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Table of Contents . . . 1-2  
Title Page . . . 3  
SALSB Executive Board . . . 4  
Editorial Policy . . . 5  
Notes for authors . . . 7  
Call for Papers . . . 9

Nicholas C. Misenti. . . 11

Personal Liability for Commission of a Tort: A Significant, and Often Overlooked, Exception to Limited Liability in the LLC and Corporation

Charlie Penrod, Kimberly McCorkle, and Susan Harrell. . . 39

Doing While Learning: How Business Programs Can Integrate Beneficial Experiential Learning Opportunities for Pre-Law Business Students

Thomas M. Krueger and Mark A. Wrolstad. . . 68

Looking Beyond the Pale: Evidence that Investors Look Beyond Concurrent Annualized Returns in Assigning Corporate Reputations

Evan A. Peterson & Dhruv S. Patel. . . 92

Benefit Corporations: Fostering Socially Conscious Corporate Leadership

Rafik Elias . . . 109

The Relationship between the Protestant Work Ethic, Empathy and Business Students' Distrust of Corporations

Brad Reid . . . 123

Employment Contract or Mere Words? – The Traps Workers Face

Kana Ng and David E. Ritter . . . 137

Medicaid Expansion and Activity Based Costing as a Means of Measuring Efficiency and Improvement in Healthcare

Laura Sullivan, Dirrell S. Jones and Diana Brown. . . 149

Attorney Misconduct and the Role of the Grievance Process in Civil Proceedings Arising from the Same Facts

Jonathan R. Everhart. . . 160

Back to Business: A Practical Guide on How to Reinstate Involuntarily Terminated & Forfeited Business Entities in Texas

Table of Contents, Continued.

Michael S. Cedillo, Laura Sullivan and Diana Brown . . . 170  
Avoiding Imputed Disqualification

Charles Bultena, Charles Ramser, & Kris Tilker . . . 181  
Mediation Madness II: Dealing with Destructive Emotions

Justin Blount, Carol S. Wright, Ashley A. Hall, and Judith L. Biss . . . 202  
Social Media: Creating Student Awareness of its use in the Hiring Process

Laura Sullivan, William Hogg and Diana Brown . . . 219  
Statistical Extrapolation in Complex Litigation: Science or Guesswork?

Bret N. Bogenschneider . . . 237  
The Professional Ethics of U.S. Tax Treaty Interpretation

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**From the Editor-in-Chief. . . .**

This is the 8<sup>th</sup> volume of the *Southern Journal of Business and Ethics*, an official publication of the Southern Academy of Legal Studies in Business. The Journal is being published in hardcopy and electronically on the Southern Academy's web page at <http://www.salsb.org>.

The SJBE has been included in Ebsco Host services, allowing for full text search on most university library systems! This provides a great benefit to our authors and readers!

All articles that appear in this volume of the *Southern Journal of Business and Ethics* have been recommended for publication by the Advisory Editors, using a double, blind peer review process. A personal thanks is extended to the Advisory Editors for all their hard work and dedication to the *Journal* and the Southern Academy; without their work, the publication of this Journal would be impossible.

This is my eighth year as Editor-in-Chief, and I wish to express my sincere thanks and appreciation to all the Officers of the Southern Academy for their support, encouragement, assistance and advice throughout this year. I would like to further express appreciation to Will Mawer of Southeastern Oklahoma State University, for his efforts in coordinating the start of the Journal. The publishing of this journal is an intense educational experience which I continue to enjoy.

Many of the papers herein were presented at the Southern Academy of Legal Studies in Business meeting in San Antonio, Texas, April, 2016. Congratulations to all our authors. I extend a hearty invitation to the 2017 meeting of the SALSBS in San Antonio, Texas, April, 2017.

The Southern Academy annual meeting has been voted the "BEST REGIONAL" among all the regions affiliated with the Academy of Legal Studies in Business (ALSB) featuring over 60 authors and 50 papers. I hope to see ya'll in San Antonio! Please check the web site ([www.salsb.org](http://www.salsb.org)) for further information. To further the objectives of the Southern Academy, all comments, critiques, or criticisms would be greatly appreciated.

Again, thanks to all the members of the Southern Academy for allowing me the opportunity to serve you as editor-in-chief of the Journal.

**M.P. (Marty) Ludlum**

**Editor-in-Chief**

*Southern Journal of Business and Ethics*

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### Notes for Authors:

The focus of the **Southern Journal of Business and Ethics (SJBE)** is to examine the current trends and controversies in business, law and ethics, both domestic and international. In addition, future issues will include a new section, *Short Notes*, which will consist of shorter articles focusing on pedagogical ideas for the new business law instructor.

All authors promise that any submission is original work, and has not been previously published.

Since the topics of **SJBE** cross into many different academic areas, the **SJBE** does not have a specific format. Authors are free to use Chicago style, Harvard style or the APA, as long as the application is consistent throughout the paper.

The title should be in ALL CAPS. The text should be in Times New Romans 12 point font for the text and 10 point font for the footnotes. Authors' names should be centered below the title. Paragraphs should be indented five spaces.

The maximum size for a paper is twenty-five pages, all inclusive, single spaced. Articles substantially longer may be accepted as space allows.

All submissions should include a complete copy (with author identification) and a blind copy (with author identification left blank).

All submissions are electronic, in MS-Word format. No paper copies will be reviewed or returned.

Artwork is discouraged. Tables and charts should be kept to a minimum and should be included in an appendix following the paper.

Submissions deadline is 45 days after the SALSBS spring meeting each year. Articles sent after the deadline will be reviewed for the next issue, or may be withdrawn by the author and submitted elsewhere.

Look for the call for papers at the Southern Academy's website ([www.salsb.org](http://www.salsb.org)). If you would like to serve **SJBE** as a reviewer, your efforts would be appreciated. Many hands make light work.

If you have any questions, please submit them to the Editor in Chief.

Please submit all papers to:  
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**PERSONAL LIABILITY FOR COMMISSION OF A TORT:  
A SIGNIFICANT, AND OFTEN OVERLOOKED, EXCEPTION TO LIMITED  
LIABILITY IN THE LLC AND CORPORATION**

NICHOLAS C. MISENTI\*

**ABSTRACT**

*An important, but little understood, exception to LLC and corporate limited liability shields exists: namely, limited liability shields contain a carve out for the common law rule that imposes personal liability on members and shareholders who personally commit of a tort. Personal liability applies even though the entity is also liable under Respondeat Superior. Personal liability also doesn't require piercing of the veil of limited liability. Liability is direct, and due to the conduct of the member or shareholder. Personal liability here can be extremely broad-based. Contract disputes are common in practice. Cases demonstrate that it is not difficult in this circumstance to find allegations of alleged negligent conduct. Where a closely-held LLC or corporation involved, it's likely a member or shareholder will have been personally involved in carrying out the contract. Thus, exposure to personal liability for commission of a tort is heightened, and can represent a wholesale exception to limited liability shields. In the case of entities that provide professional services, exposure of members and shareholders to personal liability for commission of a tort is a certainty. Two potential defenses exist: An Illinois LLC, and the Economic Loss Doctrine. Both provide opportunities, but raise serious ethical issues. An Illinois LLC insulates members from personal liability for all tortious conduct, even in the case of intentional misconduct. Illinois is unique in this regard. The Economic Loss Doctrine includes a confusing and inconsistent array of exceptions. But, where it applies, it bars a tort action against the entity, and its members or shareholders. In general, neither defense will apply in the case of members or shareholders who provide professional services. Finally, business owners and practitioners may not be aware of this area of law, which can result in serious issues. Further education is warranted. However, consideration should also be given to reforming limited liability shields to limit personal liability of members and shareholders that emerges from a contract to cases of intentional misconduct.*

John operates a CPA practice as a sole proprietorship. He commits negligence in performing an audit, which cost his client \$500,000 in damages. Because of financial issues, John had let his E & O insurance policy lapse. The sole proprietorship has a minimal value.

John operates a CPA practice as a limited liability company. He is careful to ensure that he signs all engagement letters as an agent of the LLC, and separates his personal finances from that of the LLC. He commits negligence in performing an audit, which cost his client \$500,000 in

---

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damages. Because of financial issues, John had let his E & O insurance policy lapse. The LLC has a minimal value.

In which scenario is John personally liable for the \$500,000 in damages? The answer is: In both scenarios. The LLC offers no protection to John.

## INTRODUCTION

Virtually all practitioners are familiar with the concept of limited liability: i.e., the statutory rule that a member of an LLC, or a shareholder in a corporation, is not personally liable for the entity's debts. However, many practitioners are not aware of a significant limitation to limited liability protection: namely, that limited liability only provides that personal liability cannot be imposed on a member or shareholder *by virtue of his being a member or shareholder*.<sup>1</sup> Thus, where a member or shareholder personally commits a tort, he is personally liable for that tort.<sup>2</sup> Personal liability in this situation is not being imposed on the member or shareholder due to the fact that he is a member or shareholder. Personal liability is direct, and due to the conduct of the member or shareholder. Further, the member or shareholder is personally liable even though he was acting as an agent of the LLC or corporation at the time; i.e., even though the LLC or corporation is *also* liable under *Respondeat Superior*.<sup>3</sup>

Personal liability for commission of a tort also does not require piercing of the veil of limited liability.<sup>4</sup> Further, the risk of personal liability due to commission of a tort is higher than the risk that is posed by the doctrine of piercing the veil of limited liability, which, according to the courts, is applied only in exceptional circumstances.<sup>5</sup> This raises serious questions concerning the fairness of the limited liability shield, given that piercing of the veil of limited liability is usually thought of as the main (or only) exception to limited liability. Contract disputes are common in practice, and a normal part of doing business. It is not difficult to find facts that could amount to negligence by the other party where the other party has undertaken an active role in carrying out the contract. Thus, exposure to personal liability for commission of a tort can be significant.

The risk is highest in the closely held corporation or LLC, where the activities of the member or shareholder are more likely to rise to the level so as to satisfy elements of various tort and statutory claims. In fact, in the solely owned corporation or LLC that provides professional services, such as a CPA firm, law firm, or physician's practice, the risk may be unavoidable. This raises serious issues of fairness to business owners, who may reasonably believe that when they operate in the form of an LLC or a corporation, they have limited liability if an issue as to contract performance arises, at least absent intentional wrongdoing.

Two potential defenses emerge, the Economic Loss Doctrine, and forming an LLC in Illinois, which may prevent personal liability for the commission of a tort. These defenses also may not be apparent to many business owners and practitioners. Both potential defenses raise serious ethical issues.

The Economic Loss doctrine is supposed to limit disputes that arise out of a contract, and involve only economic damages, to a breach of contract action against the LLC or corporation.<sup>6</sup>

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<sup>1</sup> See, e.g., Section 304(a) of the Uniform Limited Liability Company Act of 2006 (Amended 2013)

<sup>2</sup> *Kilduff v. Adams, Inc.*, 593 A.2d 478, 488 (Conn. 1991).

<sup>3</sup> THE RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 7.01 (2006)

<sup>4</sup> See, e.g., *Sturm v. Harb Dev., LLC*, 138 2 A.3d 859, 869-70 (Conn. 2010)

<sup>5</sup> See, e.g., *Pardo v. Wilson Line of Washington, Inc.* 414 F.2d 1145, 1149 (U.S. App. D.C. 1969)

<sup>6</sup> See, e.g., § 56 65 C.J.S. Negligence Sec. 56

However, the doctrine today contains so many exceptions, and is so unevenly applied, sometimes even within the same jurisdiction, that in many cases it is rendered meaningless. The result is a corporate shareholder or LLC member who may have to unfairly defend against claims of personal liability based on the alleged commission of various torts, in what really is a breach of contract action against the entity. On the other hand, where the doctrine does apply, it bars both tort claims against the entity as well as its members or shareholders, which may be unfair to plaintiffs with legitimate tort claims.

The Illinois LLC statute has been interpreted by the Illinois Appellate courts as creating a complete bar to claims against LLC members that are based on personal commission of a tort.<sup>7</sup> This offers planning opportunities to business owners who aware of this exception, but it also raises serious questions of fairness for plaintiffs. Illinois is unique with respect to this interpretation of the limited liability shield. The Illinois exception does not apply to Illinois corporations, or LLC's that render professional services, because separate limited liability shields govern those entities.

### **THE RULE: PERSONAL LIABILITY OF AN AGENT FOR COMMISSION OF A TORT**

It is a well-established common law rule that an agent who commits a tort while acting on behalf of a principal is personally liable for that tort. This rule is so fundamental that it has been termed "black letter law."<sup>8</sup> The Restatement (Third) of the Law of Agency § 7.01 (2006) summarizes the common law personal liability rule this way:

An agent is subject to liability to a third party harmed by the agent's tortious conduct. *Unless an applicable statute provides otherwise*, an actor remains subject to liability although the actor acts as an agent or an employee, with actual or apparent authority, or within the scope of employment (emphasis added).

Comment b. to § 7.01 explains the rationale for the rule:

The justification for this basic rule is that a person is responsible for the legal consequences of torts committed by that person. A tort committed by an agent constitutes a wrong to the tort's victim independently of the capacity in which the agent committed the tort. The injury suffered by the victim of a tort is the same regardless of whether the tortfeasor acted independently or happened to be acting as an agent or employee of another person.

Further, "an actor remains subject to liability although the actor acts as an agent or an employee, with actual or apparent authority, or within the scope of employment."<sup>9</sup> Thus, personal liability applies irrespective of whether the member or shareholder was acting on behalf of the LLC or corporation at the time, i.e., irrespective of whether the entity also is liable under the doctrine of *Respondet Superior*. Case law clearly establishes that the issue isn't whether a member

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<sup>7</sup> Puleo v. Topel, 856 N.E.2d 1152 (Ill. App. 2006); Carollo v. Irwin, 959 N.E.2d 77 (Ill. App. 1st 2011); Dass v. Yale, 3 N.E.3d 858, 866 (Ill. App. 1st 2013)

<sup>8</sup> Kilduff v. Adams, Inc., 593 A.2d 478, 488 (Conn. 1991).

<sup>9</sup> THE RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 7.01 (2006). See also, Sturm v. Harb Dev., LLC, 2 A.3d 859, 866 (Conn. 2010).

or shareholder can be held liable for his own tortious conduct such as negligence, but, instead, whether or not each of the elements of the tort with respect to the member or shareholder have been established by the plaintiff.

### PIERCING OF THE VEIL OF LIMITED LIABILITY DISTINGUISHED

Personal liability for commission of a tort should not be confused with the doctrine of piercing of the veil of limited liability. Simply put, it is not necessary to plead or prove piercing of the veil of limited liability to hold a member of an LLC or a shareholder in a corporation personally liable for his own tortious conduct. It is the conduct of the member or shareholder that engenders personal liability in this situation.<sup>10</sup> Liability is based on the common law rule that imposes personal liability for commission of a tort, which is excepted from LLC and corporate limited liability shields. In short, the liability is direct. In reversing a trial court's ruling that had dismissed claims for negligence, negligent misrepresentation, and fraudulent misrepresentation against a contractor personally because the plaintiff had failed to plead or prove piercing of the veil of limited liability that governed the contractor's LLC, the Connecticut Supreme Court held that:

The trial court thus improperly concluded that the plaintiffs were required to allege facts sufficient to pierce the corporate veil with regard to all of the counts of the complaint alleged against the defendant in his individual capacity. The trial court improperly failed to consider the common-law tort exception that the plaintiffs chose to invoke as the basis for their individual claims against the defendant. The trial court therefore improperly struck all of the counts against the defendant in his individual capacity for the plaintiffs' failure to make allegations sufficient to pierce the corporate veil.<sup>11</sup>

A Texas Appeals Court explained it similarly:

We believe Mulvaney's argument that liability could be imposed on him only if the Sanchezes pierced Hypersonic's corporate veil misconstrues the non-contract claims brought against him. \*\*\*

The issue of a defendant's liability in his individual capacity is distinct from that of his liability under an alter ego theory. A corporation's agent is personally liable for his own fraudulent or tortious acts, even when acting within the course and scope of his employment. *See Miller v. Keyser*, 90 S.W.3d 712, 717 (Tex.2002); *Cimarron Hydrocarbons Corp. v. Carpenter*, 143 S.W.3d 560, 564 (Tex. App.—Dallas 2004, pet. denied); *Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex. App.—San Antonio 2003, pet. denied). In an action seeking to hold an agent individually liable for his tortious or fraudulent acts, the corporate veil is not required to be pierced. *Gore*, 136 S.W.3d at 32; *Kingston v. Helm*, 82 S.W.3d 755, 761 (Corpus Christi 2002, pet. denied).<sup>12</sup>

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<sup>10</sup> The doctrine of periling of the veil of limited liability is a complex doctrine that is not applied consistently across jurisdictions. A discussion of the doctrine is beyond the scope of this paper.

<sup>11</sup> *Sturm v. Harb Dev., LLC*, 138 2 A.3d 859, 869-70 (Conn. 2010)

<sup>12</sup> *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App. 2008)

Of course, holding a member or shareholder personally liable *for breach of contract*, as opposed to tortious conduct, would require pleading and proving piercing of the veil of limited liability where a member or shareholder properly signs a contract as an agent for a fully disclosed LLC or corporation.<sup>13</sup> Allegations that a member or shareholder engaged in tortious conduct while carrying out the entity's contract represent a way to get around this limitation. In many respects, this represents a bigger threat than piercing of the veil of limited liability.

It's true that the consequences of piercing the veil of limited liability can be catastrophic because the member or shareholder will be personally liability for all of the entity's debts, and not just for damages engendered by the member's or shareholder's own tortious conduct. The entity will be liable as a result of the tortious conduct of the member or shareholder, another member or shareholder, or any employee, who was acting within the scope of the business at the time he committed a tort, under the doctrine of *Respondeat Superior*. The entity would be liable for contracts it entered into. If the doctrine of piercing the veil of limited liability is applied, the member or shareholder can be held personally liable for all of these obligations. Thus, when the doctrine is applied, personal liability is broad-based.

On the other hand, courts have generally held that the doctrine should be applied "reluctantly"<sup>14</sup> and "cautiously"<sup>15</sup>, and that the doctrine should be applied only in "factual circumstances which are clearly extraordinary—where to do otherwise would 'subvert the ends of justice.'"<sup>16</sup>

In contrast, the circumstances where personal liability is imposed on a member or shareholder for commission of a tort are not always extraordinary. In many cases, allegations sounding in tort are asserted against members and shareholders personally where a party is unsatisfied with the performance of the other party and the case essentially really is a breach of contract case against the entity. In this sense, the risk of personal liability being imposed for the commission of a tort, based on common law liability, is higher than the risk that is posed by piercing the veil of limited liability, especially when tort allegations are based on ordinary negligence.

Further, in some circumstances, such as professional malpractice, in particular by an accountant or lawyer, personal liability based on the commission of a tort is a given, assuming each element of the alleged negligence is proven. Here, again, the risk of personal liability due to common law personal liability for commission of a tort is higher than the risk that is posed by the doctrine of piercing the veil of limited liability. In short, piercing the veil of limited liability is thought of as the principal risk of personal liability in the LLC and the corporation, when in fact personal liability for commission of a tort presents a greater risk in many respects. It's questionable as to whether this result was intended or well thought out.

## **THE STANDARD STATUTORY LIMITED LIABILITY SHIELD**

Because personal liability of an agent applies "(u)nless an applicable statute provides otherwise"<sup>17</sup>, attention must turn to the statutory protection afforded by LLC and corporate limited

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<sup>13</sup> *Id.* at 712

<sup>14</sup> *Pardo v. Wilson Line of Washington, Inc.* 414 F.2d 1145, 1149 (U.S. App. D.C. 1969)

<sup>15</sup> *Country Maid, Inc. v. Haseotes* 299 F. Supp. 633, 637 (E.D.Pa.1969),

<sup>16</sup> *Johnson & Higgins of Miss., Inc. v. Comm'r of Ins.*, 321 So.2d 281, 284 (Miss.1975)

<sup>17</sup> THE RESTATEMENT (THIRD) OF THE LAW OF AGENCY § 7.01 (2006).

liability shields to a member or shareholder who commits a tort.

### *The LLC Shield*

The LLC limited liability shield typically provides that a member or manager of an LLC is not personally liable *solely by reason of being a member or manager*. Thus, e.g., Section 304(a) of the Uniform Limited Liability Company Act of 2006 (Amended 2013), provides that:

A debt, obligation, or other liability of a limited liability company is solely the debt, obligation, or other liability of the company. A member or manager is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the company *solely by reason of being or acting as a member or manager.*" (emphasis added).<sup>18</sup>

This language is common even in states that have not adopted the Uniform Limited Liability Company Act. E.g., CGS Sec.'s 33-133 and 34-134 provide the general limited liability shield for an LLC formed in Connecticut. CGS Sec. 33-133(a) provides that:

Except as provided in subsection (b) of this section, a person who is a member or manager of a limited liability company is not liable, *solely by reason of being a member or manager*, under a judgment, decree or order of a court, or in any other manner, for a debt, obligation or liability of the limited liability company, whether arising in contract, tort or otherwise or for the acts or omissions of any other member, manager, agent or employee of the limited liability company (emphasis added).<sup>19</sup>

CGS Sec. 34-134 provides that:

A member or manager of a limited liability company is not a proper party to a proceeding by or against a limited liability company *solely by reason of being a member or manager of the limited liability company.* . . . (emphasis added).

This language is unnecessarily ambiguous, especially compared to the typical corporate shield.

### *The Corporate Shield*

Section 6.22(b) of the Model Business Corporations Act (2010) provides that "a shareholder of a corporation is not personally liable for the acts or debts of the corporation *except that he may become personally liable by reason of his own acts or conduct* (emphasis added)." States that have adopted the MBCA can be expected to include the same language.<sup>20</sup>

However, similar language is found in states that have not adopted the MBCA. Thus,

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<sup>18</sup> Connecticut has passed the Uniform Limited Liability Company Act, effective July 1, 2017. Public Act No. 16-97. Sec. 38(a) of the Act substitutes the language from 304(a) of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*) for the existing language in CGS Sec.'s 33-133 and 34-134.

<sup>19</sup> CGS Sec. 33-133(b) provides a carve out for professional services, and is discussed below.

<sup>20</sup> See, e.g., CGS Sec. 33-673(b)

Delaware has not adopted the MBCA, but provides that unless the certificate of incorporation provides otherwise, "the stockholders of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts".<sup>21</sup>

While the language that governs the corporate limited liability shield is less ambiguous than its LLC counterpart, the corporate shield is not without its faults. E.g., the language in the corporate shield leaves to the vagaries of the common law questions such as whether personal liability for economic loss extends beyond intentional conduct.

## **THE LIMITED LIABILITY SHIELD THAT GOVERNS PROFESSIONAL SERVICES**

Most states provide a very specific carve out from the limited liability shield when the LLC or corporation renders professional services. The carve out codifies the common law rule that individuals are personally liable when they commit malpractice or other tortious conduct while rendering professional services, even when operating in the LLC or corporate form. Here, personal liability is all but certain, assuming tortious conduct is proven.

### *The LLC Professional Services Shield*

The language in the Connecticut provision is commonplace. CGS Sec. 34-133(b) provides that:

*Nothing contained in sections 34-100 to 34-242, inclusive, shall be interpreted to abolish, repeal, modify, restrict or limit the law in effect on October 1, 1993, in this state applicable to the professional relationship and liabilities between the person furnishing the professional services and the person receiving such professional service and to the standards for professional conduct; provided any member, manager, agent or employee of a limited liability company rendering professional services formed under sections 34-100 to 34-242, inclusive, shall be personally liable and accountable *only for negligent or wrongful acts or misconduct committed by him, or by any person under his direct supervision and control*, while rendering professional services on behalf of the limited liability company to the person for whom such professional services were being rendered . . . (emphasis added)<sup>22</sup>*

The initial language in the provision also is typical, and clearly is designed to eliminate a possible interpretation that the statutory shield abolishes the common law rule that imposes personal liability on professionals who commit malpractice. The provision also specifically mentions "negligent or wrongful acts or misconduct," leaving no doubt, e.g., that personal liability extends to merely negligent conduct.

The definition of the term "professional services" varies by state, but may be limited to occupations that establish a professional relationship with a client, or patient, as opposed to "blue collar" occupations that render services to customers. Thus, e.g., CGS Sec. 34-101(25) provides that:

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<sup>21</sup> 8 Del. Code Ann. Sec. 102(b)(6)

<sup>22</sup> Sec. 37(c) of Public Act 16-97 retains the same language as CGS Sec. 33-133(b) regarding personal liability for tortious conduct when rendering professional services.

“Professional service” means any type of service to the public that requires that members of a profession rendering such service obtain a license or other legal authorization as a condition precedent to the rendition thereof, *limited to the professional services rendered by dentists, naturopaths, chiropractors, physicians and surgeons, doctors of dentistry, physical therapists, occupational therapists, podiatrists, optometrists, nurses, nurse-midwives, veterinarians, pharmacists, architects, professional engineers, or jointly by architects and professional engineers, landscape architects, real estate brokers, insurance producers, certified public accountants and public accountants, land surveyors, psychologists, attorneys-at-law, licensed marital and family therapists, licensed professional counselors, licensed or certified alcohol and drug counselors and licensed clinical social workers* (emphasis added).

Other states have a much broader definition of professionals services. E.g., 805 IL. Comp. Stat. Sec. 185/5 defines professional services to include any "profession to be licensed by the Department of Financial and Professional Regulation." This amounts to hundreds of different occupations, including many that wouldn't ordinarily be thought of as professional services, such as barbers, nail technicians, alarm installers, roofers, etc.<sup>23</sup>

### *The Corporate Professional Services Shield*

The corporate statutory limited liability shield that governs professionals is similar to its LLC counterpart. Thus, e.g., CGS 33-183e, which governs personal liability in a corporation when rendering professional services, first provides that "Nothing contained in this chapter shall be interpreted to abolish, repeal, modify, restrict or limit the law in effect on May 29, 1969, in this state . . .", and then that officers and agents of a corporation "shall be personally liable and accountable *only for* negligent or wrongful acts or misconduct committed by him, or by any person under his direct supervision and control, while rendering professional services on behalf of the corporation to the person for whom such professional services were being rendered" (emphasis added). The Connecticut corporate statute provides for a similar definition of " professional service" as the LLC statute.<sup>24</sup>

Similarly, 8 Del. Code Sec. 608 provides that:

*Nothing contained in this chapter shall be interpreted to abolish, repeal, modify, restrict or limit the law now in effect in this State, applicable to the professional relationship and the contract, tort, and other legal liabilities between the person furnishing the professional service and the person receiving the professional service, and to the standards for professional conduct, including the confidential relationship between the person rendering the professional service and the person receiving such professional service, if any; and all confidential relationships previously enjoyed under the laws of this State or hereafter enacted shall remain inviolate. Any officer, employee, agent or shareholder of a professional corporation shall remain personally and fully liable and accountable for any*

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<sup>23</sup> See list available at <http://www.idfpr.com/profs/proflist.asp>

<sup>24</sup> See CGS 33-182a(1)

*negligent, wrongful acts, or misconduct committed by such person, or by any person under such person's direct supervision and control, while rendering professional services on behalf of the professional corporation to the person for whom such professional services were being rendered . . . (emphasis added)*<sup>25</sup>

The Delaware definition of "professional services" mirrors the Connecticut provision, and thus is generally limited to services that establish a professional relationship with a client, or patient, as opposed to "blue collar" occupations that render services to customers.<sup>26</sup>

The explanation as to why the carve out to the statutory limited liability shield is so clear-cut in the case of professional services relates to the different evolution in the doctrine of limited liability for professionals, and specifically the era, through the 1950's, when professionals were not allowed to incorporate, and thus had to operate either as a sole proprietorship or general partnership with full unlimited personal liability. One, of the many, objections, to allowing professionals to incorporate was that the limited liability shield would insulate professionals from personal liability for their own torts, including malpractice, which was morally wrong.<sup>27</sup> Clearly, the language in the typical LLC limited liability shield, that a shareholder is not personally liable by virtue of being a shareholder, is, on its face, is ambiguous. The typical language that is used in the corporate shield is clearer, but still insufficient to ensure that professionals couldn't escape personal liability for malpractice. Thus, when professionals were allowed to incorporate, special care was used to ensure that the limited liability shield would preserve the common law rule that professionals are personally liable when they commit negligent or other wrongful acts. Hence the explicit language that is used in the carve out.

Consistent with the principle that it would be unethical to allow professionals to escape personal liability for malpractice through a limited liability shield, Rules of Professional Conduct also may impose personal liability for professional malpractice while operating in the LLC or corporate form. E.g., in 1970 the Ohio Supreme Court adopted Rule III, which allowed attorneys to operate in the corporate form.<sup>28</sup> Section 4 (C) of Rule III provides that:

Each officer, director, agent, employee, manager, member, partner or equity holder of a legal professional association, corporation, legal clinic, limited liability company, or limited liability partnership shall be liable for his or her own acts or omissions as provided by law, without prejudice to any contractual or other right that the person may be entitled to assert against a firm, an insurance carrier, or other third party.

## **THE STANDARD STATUTORY LLC SHIELD REEXAMINED**

Clearly, the carve out from the limited liability shield that governs an LLC or corporation

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<sup>25</sup> Curiously, Delaware does not have a specific carve out for professional services rendered by members or managers of an LLC, in contrast to a corporation, although the outcome is the same under the general LLC shield. See, *Weber v. U.S. Sterling Sec., Inc.*, 924 A2d 816, 824–25 (Conn. 2007).

<sup>26</sup> 8 Del. Code Sec. 603(1)

<sup>27</sup> See, e.g., H. Bradley Jones, *The Professional Corporation*, *Fordham Law Review*, Volume 27, Issue 3, Article 3 (1958). This 1958 article provides a summary of the objections, at the time, to professional incorporation, along with a proposal for a professional corporation statute.

<sup>28</sup> Ohio S. CT. Gov't R. III. The rule formerly was Ohio S. CT. R. XVII B (1970). See M. Thomas, Arnold, *Incorporation of Professionals in Ohio: Past, Present, and Future*, *Akron Law Review*, Volume 15:2 (1980).

that renders professional services is unambiguous. While the scope of personal liability is an issue in the general shield that governs corporations, it's clear that some type of personal liability for tortious conduct is contemplated.

In contrast, the standard LLC limited liability shield, which states that an individual is not liable "solely because he is a member or manager of an LLC", is less clear. It can be argued that this language impliedly contains a carve out from the shield for common law personal liability for the commission of a tort because such liability is based on the individual's personal conduct, and not his status as a member or shareholder. In fact, the weight of authority provides that, as a general rule, there is no difference in outcome in any of the cases, despite the difference in language: i.e., a carve out also exists under the standard LLC shield for the common law rule that imposes personal liability on an individual for negligent or other tortious conduct. Thus, e.g., the Connecticut Supreme Court has rejected the argument that the standard statutory LLC limited liability shield abrogates the common law rule that imposes personal liability on a member or manager who commits a tort while carrying out the LLC's business:

The \*\*\* defendants argue that this statute, which was enacted in 1993; see Public Acts 1993, No. 93–267, § 20; supersedes the principle that officers of corporations may be held personally liable for their conduct on behalf of a company in certain circumstances as that principle applies to limited liability companies. See *Scribner v. O'Brien, Inc.*, supra, 169 Conn. at 404, 363 A.2d 160. We disagree. “Although the legislature may eliminate a common law right by statute, the presumption that the legislature does not have such a purpose can be overcome only if the legislative intent is clearly and plainly expressed.” (Internal quotation marks omitted.) *Matthiessen v. Vanech*, 266 Conn. 822, 838–39, 836 A.2d 394 (2003). Section 34–134 evinces no legislative intent to eliminate the right to impose liability on a member or manager of a limited liability company who has engaged in or participated in the commission of tortious conduct. Rather, the statute merely codifies the well established principle that “an officer of a corporation does not incur personal liability for its torts *merely because of his official position.*” \*146 Emphasis added.) *Scribner v. O'Brien, Inc.*, supra, at 404, 363 A.2d 160. Accordingly, we reject the \*\*\* defendants' arguments that the principle that corporate officers are personally responsible for their own tortious conduct does not apply in this case.<sup>29</sup>

The Comment to Section 304(a) of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*) refers to this interpretation as "the overwhelming weight of the case law", citing the following:

See, e.g., *Mbahaba v. Morgan*, 163 N.H. 561, 565, 44 A.3d 472, 476 (2012) (“When ... a member or manager commits or participates in the commission of a tort, whether or not he acts on behalf of his LLC, he is liable to third persons injured thereby.”); *Sturm v. Harb Dev., LLC*, 298 Conn. 124, 138, 2 A.3d 859, 870 (2010) (holding that the liability shield of an LLC is subject to “the common-law tort exception ... [for] individual claims against LLC members”); *Allen v. Dackman*, 413

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<sup>29</sup>*Ventres v. Goodspeed Airport, LLC*, A.2d 937, 964 (Conn. 2005)

Md. 132, 154, 991 A.2d 1216, 1229 (2010) (“An LLC member is liable for torts he or she personally commits, inspires, or participates in because he or she personally committed a wrong, not ‘solely’ because he or she is a member of the LLC.”); *Weber v. U.S. Sterling Sec., Inc.*, 282 Conn. 722, 732–34, 924 A.2d 816, 824–25 (2007) (stating that the Delaware LLC Act “does not preclude individual liability for members of a limited liability company if that liability is not based simply on the member's affiliation with the company” and holding, in particular, that the Act “does not bar the defendants' liability for tortious conduct”).

Courts also have specifically rejected the argument that the carve out from the LLC limited liability shield that allows for personal liability for tortious conduct is limited to individuals who provide professional services. E.g., the Connecticut Supreme Court held that “The defendant's analysis fails, however, to acknowledge our well established common-law exception to individual liability in a corporate context for an individual's tort liability.”<sup>30</sup> Thus, a contractor operating in the form of an LLC could be held personally liable for tortious conduct, even though contractors do not come under the definition of individuals who provide professional services under Connecticut law.<sup>31</sup>

This is an emerging area of law. Thus, in 2012, the South Carolina Supreme Court described the issue of personal liability of LLC members and managers for tortious conduct as “a question of first impression in this State”, before holding that no immunity was provided by the LLC limited liability shield.<sup>32</sup> However, in 2013, the Court revisited the case, and withdrew this decision.<sup>33</sup> The Court found there were insufficient allegations that could support personal liability of the LLC's members and managers, and concluded “We therefore find it unnecessary to reach the novel issue of whether the LLC Act absolves an LLC member of personal liability for negligence committed while acting in furtherance of the company business.”<sup>34</sup> However, it's clear that the Court's original decision represents the general rule.

## **ELIMINATING PERSONAL LIABILITY FOR COMMISSION OF A TORT: THE ILLINOIS LLC PLANNING OPPORTUNITY AND THE ECONOMIC LOSS DOCTRINE DEFENSE**

### *The Illinois LLC Planning Opportunity*

Notwithstanding the general rule, i.e., that the standard LLC shield includes a carve out for personal liability for commission of a tort, the Illinois Appellate Court has held otherwise in *Puleo v. Topel*, based on what appears to be a unique interpretation of the history of the limited liability shield in the Illinois LLC statute.<sup>35</sup> *Prior to 1998*, 805 Ill. Comp. Stat. Sec. 180/10-10 provided the following carve out from the LLC limited liability shield:

(a) A member of a limited liability company shall be personally liable for any act,

<sup>30</sup> *Sturm v. Harb Dev., LLC*, 2 A.3d 859, 868 (Conn. 2010)

<sup>31</sup> *Id.* at 135-36, 868.

<sup>32</sup> *16 Jade St., LLC v. R. Design Const. Co.*, 728 S.E.2d 448, 451 (Sp. Ct. S.C. 2012), opinion withdrawn and superseded on reh'g sub nom. *16 Jade St., LLC v. R. Design Const. Co., LLC.*, 747 S.E.2d 770 (Sp. Ct. S.C. 2013)

<sup>33</sup> *16 Jade St., LLC v. R. Design Const. Co., LLC.*, 747 S.E.2d 770 (Sp. Ct. S.C. 2013)

<sup>34</sup> *Id.* at 773

<sup>35</sup> *Puleo v. Topel*, 856 N.E.2d 1152 (Ill. App. 2006)

debt, obligation, or liability of the limited liability company or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law.

(b) A manager of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company or another manager or member to the extent that a director of an Illinois business corporation is liable in analogous circumstances under Illinois law.

P.A. 90-424, eff. 1-1-98, amended Sec. 180/10-10 by changing section (a) and deleting section (b) to read as follows:

(a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.

(b) (Blank).<sup>36</sup>

In rejecting a claim that the defendant could be personally liable for obligations incurred on behalf of an LLC after the company was involuntarily dissolved, the Court in *Puleo* held that:

In 1998 \*\*\* the legislature amended section 10–10 and in doing so removed the above language which explicitly provided that a member or manager of an LLC could be held personally liable for his or her own actions or for the actions of the LLC to the same extent as a shareholder or director of a corporation could be held personally liable. As we have not found any legislative commentary regarding that amendment, we presume that by removing the noted statutory language, the legislature meant to shield a member or manager of an LLC from personal liability. *Drury Displays, Inc.*, 327 Ill.App.3d at 888, 261 Ill. Dec. 875, 764 N.E.2d 166 (“When a statute is amended, it is presumed that the legislature intended to change the law as it formerly existed”).<sup>37</sup>

The *Puelo* case has serious implications. The protections that are afforded to LLC members and managers, and, conversely, the detriments that befall plaintiffs who are suing based on tortious conduct, are substantial. Thus, the Illinois Appellate Court also has held that a defendant could not be held personally liable for debts incurred on behalf of an LLC prior to its formation, even though under the law of agency, the defendant would be personally liable for a contract he executed on behalf of the unformed LLC.<sup>38</sup> Here, the court stated:

We have recognized the clear legislative intent to shield individuals from personal liability in transactions on behalf of LLCs, where the LLC did not exist because it

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<sup>36</sup> Section (d) allows members to voluntarily assume personal liability in the Articles of Organization or otherwise.

<sup>37</sup> *Puleo v. Topel*, 856 N.E.2d 1152, 1157 (Ill. App. 2006)

<sup>38</sup> *Carollo v. Irwin*, 959 N.E.2d 77 (Ill. App. 1st 2011)

was dissolved. In *Puleo*, we held that a managing member was not personally liable for debts that an LLC incurred after its dissolution because there was no evidence of a provision establishing the managing member's personal liability was contained in the LLC's articles of organization or that the managing member consented in writing to the adoption of such a provision, which are the requirements of section 10–10(d) of the Limited Liability Company Act.<sup>39</sup>

The doctrine also bars recovery against LLC members and managers for claims that are based on intentional misconduct. Thus, the appellate court also has held that the manager of a limited liability company that sold condominium units to purchasers was not personally liable to purchasers for alleged fraud committed during the sale of the units because the "LLC's articles of organization did not contain a provision for manager liability, manager never consented in writing to such a provision, and express language of statute governing LLC liability had been changed to prevent manager liability."<sup>40</sup>

In short, the rule in Illinois is that a member or manager of an LLC has the power to avoid personal liability for tortious conduct simply by not agreeing to assume personal liability in the Articles of Organization or otherwise. Illinois appears to be unique in this respect. The Comment to Section 304(a) of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*) vigorously criticizes the *Puleo* decision:

This mistaken view: (i) ignores the actual words of LLC shield provisions (which protect members and managers only against liability for obligations of an LLC and make no reference to direct obligations of a member or manager); and (ii) flouts public policy (which recoils from the idea of immunizing a person's misconduct solely because the person acts on behalf of an organization). Moreover, the mistaken view is contrary to the overwhelming weight of the case law.

The court's interpretation is questionable because the new version of 805 Ill. Comp. Stat. Sec. 180/10-10(a) does state that "A member or manager is not personally liable for a debt, obligation, or liability of the company *solely by reason of being or acting as a member or manager* (emphasis added)." Other courts have held that this language preserves common law personal liability for commission of a tort.<sup>41</sup> Notwithstanding, there really is no dispute that legislatures have the power to eliminate personal liability for tortious conduct in a limited liability shield, and the court was persuaded by the legislature's elimination of the express language that made a member or manager personally liable for commission of a tort, coupled with a lack of legislative history that would justify a different interpretation. Perhaps then this criticism is misdirected, and should be placed on the Illinois legislature, which appears to have created a limited liability shield with no exceptions, other than consent to personal liability by an LLC member or manager, which can easily be avoided and, presumably, would not normally be provided. As the *Puleo* court said, "We agree with plaintiff that the circuit court's ruling does not provide an equitable result. However, the circuit court, like this court, was bound by the statutory language."<sup>42</sup>

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<sup>39</sup> *Id.* at N.E.2d 93

<sup>40</sup> *Dass v. Yale*, 3 N.E.3d 858, 866 (Ill. App. 1st 2013)

<sup>41</sup> See Comment to Section 304(a) of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*)

<sup>42</sup> *Puleo v. Topel*, 856 N.E.2d 1152, 1158 (Ill. App. 2006)

### The Illinois LLC Planning Opportunity Excludes Professionals

Right or wrong, the Puelo decision is law in Illinois, and presents one of the few planning opportunities that exists to avoid imposition of personal liability by way of a limited liability shield. It is worth noting at the outset that this opportunity does not apply in the case of the corporation because Illinois, similar to other states, provides for a much more specific carve out from the corporate limited liability shield, which allows for imposition of personal liability for the commission of a tort.<sup>43</sup>

It is also clear that the opportunity to avoid personal liability does not present itself to professionals who operate in the form of an Illinois LLC. Illinois is one of many states that have a separate limited liability shield that governs professionals. Unlike the general LLC shield, this shield is clear cut. 805 Ill. Comp. Stat. Sec 185/35(a) provides that:

Nothing contained in this Act shall be interpreted to abolish, repeal, modify, restrict, or limit the law in effect in this State on the effective date of this Act that is applicable to the professional relationship and liabilities between the person furnishing the professional services and the person receiving such professional services or the law that is applicable to the standards for professional conduct. Any manager, member, agent, or employee of a professional limited liability company shall remain personally and fully liable and accountable for any negligent or wrongful acts or misconduct committed by him or her or by any person under his or her direct supervision and control while rendering professional services on behalf of the professional limited liability company.

It can't be argued that the revision of the general Illinois LLC statute, which the Puelo court relied on, supersedes the LLC that governs professionals. The shield that governs professionals who operate in the form of an Illinois LLC was enacted after the revision of the general LLC shield. Specifically, this version of 805 Ill. Comp. Stat. Sec 185/35(a) was enacted by P.A. 99-227, § 35, eff. Aug. 3, 2015, which is subsequent to the enactment and effective date of the amendment to Section 10-10, which provides the general LLC shield. Thus, there is no doubt that there is a carve out from the limited liability shield that allows for personal liability on professionals for negligent and other wrongful conduct when they operate in the form of an Illinois LLC.<sup>44</sup>

The sheer breadth of the definition of "professional services" in Illinois is problematic. Essentially, any occupation that requires a state license is included in the definition.<sup>45</sup> Nevertheless, forming an LLC in Illinois for other purposes can provide significant protection by insulating members and managers from personal liability for tortious conduct, provided Illinois law applies when the LLC is operating in other jurisdictions. In many other cases, the Economic Loss Doctrine could prove to be a viable defense.

### Governing Law

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<sup>43</sup> *Id.* at 69, N.E.2d at 1157

<sup>44</sup> Under 805 ILCS Comp. Stat. Sec. 185/5, "professional services" includes those services "that require the individuals engaged in the profession to be licensed by the Department of Financial and Professional Regulation."

<sup>45</sup> See 805 IL. Comp. Stat. Sec. 185/5, and list of occupations that require a state license *available at* <http://www.idfpr.com/profs/proflist.asp>

The opportunity exists for anyone organizing a business, other than a business that will render professional services, to avoid personal liability for tortious conduct by forming an LLC in Illinois. Clearly, protection will exist only if Illinois law will govern the limited liability shield when the LLC is operating in other states.

The general rule is that law where the LLC is domiciled governs the "internal affairs" of the LLC<sup>46</sup>, but a legal issue exists as to whether the limited liability shield comes under the heading of "internal affairs". Anticipating this issue, Section 104 of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*) provides that:

The law of this state governs:

- (1) the internal affairs of a limited liability company; and
- (2) the liability of a member as member and a manager as manager for a debt, obligation, or other liability of a limited liability company.

The Comment to Section 304 explains why paragraph (2) was included in Section 304:

"Internal affairs" and the "liability of a member as a member" are mentioned separately because it can be argued that the liability of members and managers to third parties is not an internal affair. See, e.g., RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 (1971) (treating shareholders' liability separately from the internal affairs doctrine). A few cases subsume owner/manager liability into internal affairs, but many do not. See, e.g., *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132 (2nd Cir. 1993) (holding that the corporation's "primary purpose is to insulate shareholders from legal liability" and therefore "the state of incorporation has the greater interest in determining when and if that insulation is to be stripped away") (quoting *Soviet Pan Am Travel Effort v. Travel Comm., Inc.*, 756 F. Supp. 126, 131 (S.D.N.Y. 1991) (internal quotation marks omitted).

The Comment to Section 304 notes that the majority rule is that the law where the LLC is domiciled governs liability of its members:

See, e.g., ARIZ. REV. STAT. ANN. § 29-801(A)(1) (2013) (stating that "[t]he laws of the state or another jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its members"); GA. CODE ANN. § 14-11-701 (West 2013)(a) (stating that "[t]he laws of the jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its managers, members, and other owners"); N.Y. LTD. LIAB. CO. LAW § 801(a) (McKinney 2013) (stating that "[t]he laws of the jurisdiction under which a foreign limited liability company is formed govern its organization and internal affairs and the liability of its members and managers").

The Illinois LLC statute does not incorporate the language in Section 304, and, in fact, is silent on

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<sup>46</sup> See Comment to Section 304 of the Uniform Limited Liability Company Act (2006) (*Last Amended 2013*)

the issue. However, 805 Ill. Comp. Stat. Sec 180/45-1 provides that:

(a) The laws of the State or other jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its managers, members, and their transferees.

(b) A foreign limited liability company may not be denied admission by reason of any difference between the laws of another jurisdiction under which the foreign company is organized and the laws of this State.

If a foreign jurisdiction has a similar provision to 805 Ill. Comp. Stat. Sec 180/45-1, then the outcome, that an Illinois LLC member or manager has no personal liability for tortious conduct, is assured, if the LLC were domiciled in Illinois. The majority rule also supports this conclusion. But, there is no guarantee of this outcome because it's possible that a foreign jurisdiction will not follow the majority rule, especially because the outcome would insulate someone from personal liability for his own tortious conduct and thus be controversial.

#### Ethical Issues Raised by the Illinois LLC Planning Opportunity

The Illinois LLC also represents a unique opportunity for business owners. The Wisconsin appellate Court had ruled that the Wisconsin LLC shield insulated members and managers from personal liability for tortious conduct.<sup>47</sup> However, this decision was overturned by the Wisconsin Supreme Court.<sup>48</sup> In an unpublished decision, the Kentucky Supreme Court also held that Kentucky LLC shield insulated members and managers from personal liability for tortious conduct.<sup>49</sup> The Court reasoned in part that "an LLC cannot act except through its representatives", so to hold otherwise would essentially make members and managers personally liable by default when disputes arose with third parties.<sup>50</sup> However, in response, the Kentucky legislature amended 2010. 275 KRS 275.150 by adding Section (3), which provides that the LLC limited liability shield "shall not affect the liability of a member, manager, employee, or agent of a limited liability company for his or her own negligence, wrongful acts, or misconduct."<sup>51</sup>

It's possible that the Illinois Supreme Court will rule differently than the Appellate Court in the future, or that the Illinois LLC statute will be amended. However, given that the Illinois Appellate Court decisions were rendered between 2006 and 2013, with no responsive action from either the Illinois Supreme Court or Illinois legislature, forming an LLC in Illinois as a shield against personal liability for tortious conduct is a viable planning strategy.

Ultimately, it can be argued that the Illinois Appellate court went too far in shielding LLC members from personal liability for tortious conduct because the shield extends to willful misconduct, and to situations where there was no principal at the time the member acted. It's unlikely that most people would agree that an agent should be shielded from personal liability when they engaged in intentional misconduct, even if the principal is liable under *Respondeat Superior*. Moreover, shielding the agent from liability where there was no principal at the time the

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<sup>47</sup> *Brew City Redevelopment Grp., LLC v. The Ferchill Grp.*, 714 N.W.2d 582 (Wis. Ct. Appeals 2006), *aff'd sub nom. Brew City Redevelopment Grp., LLC v. Ferchill Grp.*, 724 N.W.2d 879 (Wis. Sp. Ct. 2006)

<sup>48</sup> *Brew City Redevelopment Grp., LLC v. Ferchill Grp.*, 724 N.W.2d 879 (Wis. Sp. Ct. 2006)

<sup>49</sup> *Barone v. Perkins*, No. 2007-CA-000838-MR, 2008 WL 2468792 (Ky. Ct. App. June 20, 2008)

<sup>50</sup> *Id.* at \*4

<sup>51</sup> See 2010 Acts Ch. 133 § 31

agent acted will almost certainly mean that the plaintiff has no remedy at all because the LLC also would not likely be liable under any theory. Most people would probably find that outcome objectionable. Even the court itself said its decision "does not provide an equitable result."<sup>52</sup> On the other hand, the Illinois Appellate court has at least raised the issue as to whether the limited liability shield exception for tortious conduct is too broad.

### *The Economic Loss Doctrine Defense*

Many claims of personal liability result from a dispute related to an underlying contract, and involve only economic damages, where one party is unsatisfied with the performance of the other party. Where the Economic Loss Doctrine applies, a tort action is precluded, and an action can only commence for breach of contract. If a member of an LLC or shareholder in a corporation properly signs a contract as an agent of a fully disclosed entity, the entity is the only party to a breach of contract action. Thus, the member or shareholder has no personal liability. In short, the Economic Loss Doctrine can represent a significant defense against a claim for personal liability that is made against a member or shareholder. Failure to plead the defense could amount to legal malpractice. The Economic Loss Doctrine has been summarized as follows<sup>53</sup>:

a plaintiff may not recover damages under a negligence claim when the plaintiff has suffered no personal injury or property damage.<sup>54</sup> The economic loss rule prevents recovery for negligence when the duty breached is a contractual duty and the harm incurred is the result of the failure of purpose of contract.<sup>55</sup> The economic loss rule prevents a plaintiff who is not in privity of contract with a defendant from maintaining an action for negligence based on purely economic losses.<sup>56</sup>

The doctrine began in California in 1965, in the context of strict liability action involving the sale of goods.<sup>57</sup> In that case, the California Supreme Court applied the doctrine and barred an action in strict liability against the manufacturer of a truck that overturned, damaging the truck but causing no personal injuries or other property damage. The court held that only an action for breach of contract could be maintained because breach of contract remedies would be sufficient to compensate the plaintiff.

Illinois has articulated one of the clearer versions of the doctrine, where it is also known as the "Moorman doctrine". The Moorman case is illustrative as to how the doctrine is applied generally. The doctrine in Illinois originated in 1982 in *Moorman Manufacturing Company v. National Tank Company*<sup>58</sup>. The Plaintiff brought the action against the manufacturer of a grain storage tank that developed a crack, causing damage only to the tank. The Illinois Supreme Court held that tort claims for strict liability, misrepresentation, and negligence, could not be maintained against the manufacturer:

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<sup>52</sup> *Puleo v. Topel*, 856 N.E.2d 1152, 1158 (Ill. App. 2006)

<sup>53</sup> § 56 65 C.J.S. Negligence Sec. 56.

<sup>54</sup> *Franklin Grove Corp. v. Drexel*, 936 A.2d 1272 (R.I. 2007); 65 C.J.S. Negligence § 56

<sup>55</sup> *United Intern. Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207 (10th Cir. 2000), *judgment aff'd*, 532 U.S. 588, 121 S. Ct. 1776 (2001) (applying Colorado law); 65 C.J.S. Negligence § 56.

<sup>56</sup> *Doe v. Irvine Scientific Sales Co., Inc.*, 7 F. Supp. 2d 737 (E.D. Va. 1998); 65 C.J.S. Negligence § 56

<sup>57</sup> *Seely v. White Motor Co.*, 403 P.2d 145 (CA 1965)

<sup>58</sup> *Moorman Mfg. Co. v. Nat'l Tank Co.*, 435 N.E.2d 443 (Ill. 1982)

Our conclusion that qualitative defects are best handled by contract, rather than tort, law applies whether the tort theory involved is strict liability or negligence. Tort theory is appropriately suited for personal injury or property damage resulting from a sudden or dangerous occurrence of the nature described above. The remedy for economic loss, loss relating to a purchaser's disappointed expectations due to deterioration, internal breakdown or nonaccidental cause, on the other hand, lies in contract.<sup>59</sup>

### Exceptions to the Economic Loss Doctrine

The Moorman court recognized three exceptions to the economic loss rule, which also serve as the *general* outline for exceptions that apply in other jurisdictions:

- (1) where the plaintiff sustained personal injury or property damage resulting from a tortious event;
- (2) where the plaintiff's damages caused by a defendant's fraud, and by extension, other intentional misconduct; and
- (3) where the plaintiff's damages are proximately caused by a negligent misrepresentation by a defendant in the business of supplying information for the guidance of others in their business transactions.<sup>60</sup>

The Illinois Supreme Court has since applied the doctrine to preclude tort claims based on services contracts, in addition to sale of goods contracts, and thus to preclude negligence actions against an architect<sup>61</sup>, and an engineer.<sup>62</sup> Notwithstanding, the Court has held that the doctrine is inapplicable as a defense in a malpractice action against an accountant:

“Accountants have long been held to be members of a skilled profession, and liable for their negligent failure to observe reasonable professional competence.” (P. Kelly, *An Overview of Accountants' Liability*, 15 Forum 579, 583 (1979).) This duty to observe reasonable professional competence exists independently of any contract. The economic loss doctrine does not bar recovery in tort for the breach of a duty that exists independently of a contract.<sup>63</sup>

Similarly, the Texas Supreme Court has held that the doctrine applies to service contracts as well as sale of goods contracts, and thus barred actions in negligence and negligent misrepresentation against an architect for malpractice.<sup>64</sup> The Court, however, has held that the doctrine does not bar a tort action based on malpractice actions against an accountant<sup>65</sup>, or against a lawyer.<sup>66</sup>

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<sup>59</sup> *Id.* at 86, N.E.2d at 450

<sup>60</sup> *Id.* at N.E.2d at 452

<sup>61</sup> 2314 Lincoln Park W. Condo. Ass'n v. Mann, Gin, Ebel & Frazier, Ltd., 555 N.E.2d 346 (Ill. 1990)

<sup>62</sup> Fireman's Fund Ins. Co. v. SEC Donohue, Inc., 679 N.E.2d 1197 (Ill. 1997)

<sup>63</sup> Congregation of the Passion, Holy Cross Province v. Touche Ross & Co., 636 N.E.2d 503, 515 (Ill. 1994)

<sup>64</sup> LAN/STV v. Martin K. Eby Const. Co., 435 S.W.3d 234 (Tex. 2014)

<sup>65</sup> Grant Thornton LLP v. Prospect High Income Fund, 314 S.W.3d 913 (Tex. 2010)

<sup>66</sup> Belt v. Oppenheimer, Blend, Harrison & Tate, Inc., 192 S.W.3d 780, 783 (Tex. 2006)

It's clear that there is a general exception that applies to accountants and lawyers, and that this exception is not limited to situations that involve providing business advice, despite the language in the third Moorman exception. This is one of the difficulties with the doctrine. Over time, exceptions have evolved in unpredictable and inconsistent ways.

Personal liability of accountants who commit malpractice is a virtual certainty because a "duty to observe reasonable professional competence exists independently of any contract."<sup>67</sup> The same can be said with respect to lawyers. Thus, the South Carolina Supreme Court has stated that:

. . . we have long held lawyers and accountants liable in tort for malpractice. *See, e.g., Lloyd v. Walters*, 276 S.C. 223, 277 S.E.2d 888 (1981) (attorney liable for economic loss to corporate shareholder when attorney breached duty to corporation); *Georganne Apparel v. Todd*, 303 S.C. 87, 399 S.E.2d 16 (Ct.App.1991) (accountant malpractice dismissed for failure to prosecute). In many cases, the lawyer or the accountant will be in privity of contract with the plaintiff. *These professionals, however, owe a duty to the client and sometimes to third parties which arises separate and distinct from the contract for services. Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 159 Ill.2d 137, 201 Ill. Dec. 71, 636 N.E.2d 503 (1994) (emphasis added).<sup>68</sup>

The exception for personal injuries is also universal. Thus, the doctrine does not arise as a defense in malpractice actions against physicians because the outcome of malpractice there will almost certainly be physical injuries.

The damage to property exception is generally held to mean damage to "other property", i.e., property that was not the subject of the contact between the parties. Thus, the U.S. Supreme Court held in an admiralty case that the doctrine barred strict liability and negligence claims against a manufacturer of a turbine engine that was defective and damaged only the turbine itself.<sup>69</sup>

Disputes involving service contracts will commonly include allegations related to workmanship, and result in tort claims against a member or shareholder, in addition to a breach of contract claim against the entity. If a case involves economic damages only, and does not involve professional services by a lawyer or accountant, the doctrine may apply and bar the torts claims against a member or shareholder. However, outside of this, there is wide disparity in how the doctrine is applied, which mars its usefulness as a defense.

### Lack of Uniformity in How the Economic Loss Rule is Applied

The Economic Loss Doctrine is not uniformly applied in different jurisdictions. Some states make a distinction between service contracts and contracts for the sale of goods, or between negligence and negligent misrepresentation. E.g., Wisconsin has not extended the doctrine to service contracts.<sup>70</sup> In similar factual scenarios, Maryland has applied the doctrine to bar claims for negligent misrepresentation<sup>71</sup>, while Florida has held that the doctrine doesn't apply to

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<sup>67</sup> *Id.* at 164, 636 N.E.2d at 515

<sup>68</sup> *Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc.*, 463 S.E.2d 85, 89 (SC. 1995)

<sup>69</sup> *See, e.g., E. River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858 (1986)

<sup>70</sup> *Ins. Co. of N. Am. v. Cease Elec. Inc.*, 688 N.W.2d 462 (WI Year)

<sup>71</sup> *Morris v. Osmose Wood Preserving*, 667 A.2d 624 (MD 1995)

negligent misrepresentation claims.<sup>72</sup> While Illinois and Texas hold that the doctrine prevents tort actions against architects and engineers,<sup>73</sup> the South Carolina Supreme Court has held otherwise, saying "We see no logical reason to insulate design professionals from liability when the relationship between the design professional and the plaintiff is such that the design professional owes a professional duty to the plaintiff arising separate and distinct from any contractual duties between the parties or with third parties."<sup>74</sup>

Inconsistencies in how the doctrine is applied can exist in the same jurisdiction. Texas has barred an action against an architect<sup>75</sup>, but allowed an action against a plumber<sup>76</sup>, without explaining the distinction. In both cases, allegations of unsatisfactory workmanship led to damage to a home. It's possible to rationalize the decisions in the cases by concluding that the plumber, but not the architect, caused damage to "other property", although the court didn't provide this analysis in either case. It could be that a negligence action was allowed against the plumber because the plumber's work led to extensive damage to a home as a result of flooding, while the architect's workmanship allegedly led to more routine issues, such as cracks in the home's foundation due to settling. This suggests that courts may also subjectively weigh the circumstances, and in particular the extent of the damages, in deciding whether or not to apply the doctrine.

Malpractice actions also can extend beyond accountants and lawyers. E.g., Florida law permits tort actions under two circumstances: for intentional torts such as fraud, and when a plaintiff is suing a defendant for professional negligence.<sup>77</sup> Unlike Illinois and Texas, the Florida Supreme Court has held that the Economic Loss Doctrine does not bar a malpractice action against an engineer.<sup>78</sup> The Court noted that under Florida law, a "professional" is broadly defined for purposes of the statute of limitations for professional malpractice actions to include a person engaged in a vocation requiring at a minimum a four-year college degree before licensing is possible.<sup>79</sup> Further, the court also noted that the Florida statute that allows professionals to incorporate contains a clear carve out from the limited liability shield that imposes personal liability for negligence by professionals.<sup>80</sup> Thus, the definition of "professional services," and the specific carve out from the limited liability shield, which governs personal liability of professionals, may be dispositive of the issue of whether the doctrine will provide a viable defense to a malpractice claim.

### *Ethical Issues Involving the Economic Loss Doctrine*

The Economic Loss doctrine can be thought of as an indirect way of insulating LLC members and corporate shareholders against personal liability for alleged tortious conduct. Where a contract is between the plaintiff and the entity, and the plaintiff suffers only economic damages, the doctrine, if it's applied, limits the plaintiff to breach of contract case against the entity. Thus, actions against the member or shareholder for alleged tortious conduct are barred.

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<sup>72</sup> Pulte Home Corp. v. Osmose Wood Preserving, Inc., 60 F.3d 734, 738 (11th Cir. 1995)

<sup>73</sup> See 2314 Lincoln Park W. Condo. Ass'n, (fn. 35); Fireman's Fund Ins. Co (fn. 36); LAN/STV (fn. 36)

<sup>74</sup> Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc., 463 S.E.2d 85, 89 (SC 1995)

<sup>75</sup> LAN/STV v. Martin K. Eby Const. Co., 435 S.W.3d 234 (Tex. 2014)

<sup>76</sup> Chapman Custom Homes, Inc. v. Dallas Plumbing Co., 445 S.W.3d 716 (Tex. 2014)

<sup>77</sup> In re All Am. Semiconductor, Inc., 490 B.R. 418, 429 (Bankr. S.D. Fla. 2013)

<sup>78</sup> Moransais v. Heathman, 744 So. 2d 973 (Fla. 1999)

<sup>79</sup> *Id.* at 976.

<sup>80</sup> *Id.* at 978.

One problem with the Economic Loss Doctrine is that it is riddled with a confusing array of exceptions and inconsistencies, making it an ineffective substitute for a sound limited liability shield, and an ineffective adjunct to a weak limited liability shield. Further, the idea that professionals, or just certain professionals such as accountants and lawyers, should be excepted from the doctrine is antiquated and questionable at best. Finally, where the doctrine is applied, it bars tort actions against the entity, as well as its members or shareholders, while the purpose of a limited liability shield is to limit only the latter.

### **PERSONAL LIABILITY FOR COMMISSION OF A TORT CAN REPRESENT A WHOLESALE EXCEPTION TO LIMITED LIABILITY SHIELDS**

There is an inherent unfairness to business owners because cases where personal liability is imposed for commission of a tort are hardly exceptional, and instead typically arise when one party is dissatisfied with the performance of the other party. This really is a normal part of doing business, where the action should be limited to breach of contract against the entity.

Cases that illustrate this point abound. The Economic Loss Doctrine cases provide good examples. These cases clearly demonstrate that if one party is unsatisfied with the performance of the LLC or corporation on the contract, then the LLC member or corporate shareholder is exposed to a claim of personal liability for commission of a tort if he had any personal involvement in the carrying out of the contract.

#### *Low, et al. vs. Trump University, LLC., et. al*

Low, et al. Vs. Trump University, LLC., et. al.<sup>81</sup> provides another good example. The Trump case actually illustrates several principles: (1) Disputes that result from dissatisfaction with the other party's performance on a contract will commonly result in litigation where tort and statutory causes of action against a member or shareholder personally will be joined with a breach of contract count against the entity. (2) Even the most sophisticated business structure is not enough to prevent imposition of personal liability for the commission of a tort (or for alleged statutory violations). (3) Proper pleading that includes fairly routine allegations of a shareholder's or LLC member's involvement in carrying out the contract may be sufficient to impose liability on the shareholder or member for tortious conduct.

The Trump case was brought against both Trump University, LLC, and Donald Trump personally, for alleged "fraud" in connection with the marketing and operation of Trump University. The case essentially grew out of customers' disaffection with the information and advice provided by programs they purchased. This fact, and the multiple counts in the Complaint, prove the first principle. The Complaint includes counts for:

1. Violation of California's Unfair Competition Law ("UCL");
2. Violation of California's False Advertising Law ("FAL");
3. Violation of California's Consumers Legal Remedies Act ("CLRA");
4. Financial elder abuse under California law, Cal. Welf. & Inst. Code Section 15600;

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<sup>81</sup> The case is currently pending in the United States District Court for the Southern District of California. Docket No. 3:10-cv-00940. A jury trial is set for after the 2016 presidential election. The case was formerly known as Makaeff, et al v. Trump University, LLC, et al. Litigation documents *also are available at* <http://www.trumpuniversitylitigation.com/Home/Documents>

5. Violation of New York's consumer protection statute, Section 349 of NY's General Bus. Law;
6. Violation of Florida's consumer protection statute and elder abuse law, Florida Deceptive and Unfair Trade Practices Act ("FDUTPA");
7. Violation of Florida's Misleading Advertising Law ("MAL");
8. Negligent Misrepresentation;
9. Fraud;
10. False Promise;
11. Unjust Enrichment;
12. Money had and Received;
13. Breach of the Covenant of Good faith and Fair Dealing (against Trump University, LLC only); and
14. Breach of Contract Dealing (against Trump University, LLC only).<sup>82</sup>

What arguably is just a breach of contract case against Trump's LLC was expanded into a 14 count Complaint, with 12 of those counts alleged against Donald Trump personally. While a number of these counts are statutory, five counts (8-12) are based on alleged tortious conduct by Donald Trump. It's a given that we live in a litigious society. It's also a common practice for plaintiff's lawyers to use a "shotgun" approach such as this in pleading, and include as many counts as could possibly be imagined, sounding in contract, tort, and alleged statutory violations, against many parties as possible. That this practice is the norm calls into question the overly-broad exception to the limited liability shield for alleged tortious conduct.

Even a complex business structure offers no defense to potential personal liability due to allegations of tortious conduct. Trump set up a sophisticated business structure to operate the program. According to the Complaint, Trump University, LLC, which later became The Trump Entrepreneur Initiative LLC, ran the university. Trump University, LLC, in turn, was part of the Trump Organization, a conglomerate of companies of which Donald Trump is Chairman of the board of directors, President and CEO. Money from Trump University, LLC was distributed to Donald Trump through, in the words of the plaintiffs, two "shell" companies, namely DJT University Managing Member LLC (currently DJT Entrepreneur Managing Member, LLC), and DJT University Member, LLC (currently DJT Entrepreneur Member LLC).<sup>83</sup> This structure did not change the outcome when the court denied Donald Trump's personal Motion for Summary Judgment, which proves the second principle.

The Complaint is 84 pages long and contains allegations of misstatements by the LLC, with whom the plaintiff's contracted, and Donald Trump's personal participation in organizing, promoting, and running the programs.<sup>84</sup> A significant portion of Donald Trump's Motion was based on what he described as his limited involvement in Trump University, LLC:

Mr. Trump replies that – even though he reviewed and approved advertisements, had an ownership stake in TU indirectly through two other limited liability companies (of which he is the controlling member), and periodically reviewed TU

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<sup>82</sup> Compl. ¶ 20

<sup>83</sup> Id at ¶¶ 32 and 34

<sup>84</sup> Id at ¶ 65

financial statements – Mr. Trump is not personally liable because he did not control the day-to-day operations of TU.<sup>85</sup>

The court's decision denying Donald Trump's Motion essentially came down to the allegations of Donald Trump's personal participation in promoting and running the program. In denying the Motion with respect to the plaintiffs' UCL, FAL, and CLRA claims, the court said:

Plaintiffs point to the following connections between Mr. Trump and TU:

(1) Mr. Trump is the founder and Chairman of TU, and authorized TU to use his name, feature Mr. Trump's quotes, image, logo, and signature; (2) TU's print advertisements, email correspondence, letters, and TU website content prominently feature Mr. Trump's quotes, image, logo, and signature; (3) Mr. Trump reviewed and authorized advertisements; (4) Mr. Trump personally financed TU and reviewed financials; and (5) Mr. Trump represented that he hand-picked the TU instructors and mentors. (ECF No. 386 at 30.)<sup>86</sup>

Thus, "the Court concludes that Plaintiffs have raised a genuine dispute of material fact as to whether Mr. Trump can be personally liable for the alleged misrepresentations and misconduct."<sup>87</sup>

Concerning the issue as to how Donald Trump could be held personally liable when the university was operating as an LLC, the court cited the common law rule that an agent is liable for his own tortious conduct, irrespective of the fact that his principal may also be liable under *Respondeat Superior*, and despite a limited liability shield:

See also *Coastal Abstract Serv., Inc. v. First Am. Title Ins. Co.*, 173 F.3d 725, 734 (9th Cir. 1999) ("A corporate officer or director is, in general, personally liable for all torts which he authorizes or directs or in which he participates, notwithstanding that he acted as an agent of the corporation and not on his own behalf." (internal quotation marks and citation omitted) . . .<sup>88</sup>

Trump's personal involvement in the enterprise appears to have been minimal at best, and hardly noteworthy. This is not unexpected. It would be hard to believe that with the breadth and scope of all of Trump's business dealings, he would have been personally involved to any significant extent in the Trump University enterprise. In short, minimal allegations of personal involvement may be sufficient to trigger personal liability for tortious conduct, based really on the other party's dissatisfaction with the outcome of the contract. With respect to the small business owner who is operating a closely held LLC or corporation, more extensive personal involvement can be expected. The result essentially is a wholesale exception to limited liability when one party is dissatisfied with the other party's performance, which seems unfair at best.

*Jennings v. Smith*

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<sup>85</sup> Order Granting in Part and Denying in Part Defendants' Motions for Summary Judgment, Nov. 18, 2015, p. 18

<sup>86</sup> *Id.* at p. 22

<sup>87</sup> *Id.* at p. 23

<sup>88</sup> *Id.* at p. 22

Jennings v. Smith<sup>89</sup> also illustrates how fairly simple allegations of personal involvement in carrying out a contract can create an exception to the limited liability shield. In Jennings, the plaintiffs had contracted with Smith's corporation to build a home. The home developed a number of structural issues due to settlement of the soil. The plaintiffs brought suit against Smith personally for negligent construction and fraudulent concealment. The trial court granted Smith's Motion for Summary judgment. In reversing the trial court's decision on the negligent construction count, the Court said:

Catherine Hohlstein, a real estate agent, testified that she had seen Smith personally instructing a worker in how to repair a leak in the basement and a crack in the garage floor. Jennings testified that she had seen Smith personally supervising workers repairing leaks in the garage walls, repairing cracks and correcting settlement problems in the driveway, constructing the rear deck, and filling sinkholes in the property. Given this evidence, if a jury found the corporation negligent in constructing or repairing the house, it could also find Smith personally liable for such negligence because he specifically directed or participated in the construction and repairs. See *Brown*, supra, 212 Ga. App. 275, 441 S.E.2d 876 (reversing grant of summary judgment to corporate officer on claim of negligent construction); *Weir v. McGill*, 203 Ga. App. 431, 432-433(3), 417 S.E.2d 57 (1992).<sup>90</sup>

It's clear an LLC or corporation can't construct a house on its own, which means that in virtually all cases that involve a closely-held LLC or corporation, a member or shareholder will be exposed to allegations of tortious conduct if the homeowner is unsatisfied with the result, which isn't that uncommon. For the small business owner, the limited liability shield may prove to be worthless because he will likely have been directly involved in carrying out the entity's contracts. This isn't the expectation of most people, and raises a serious issue of fairness in how the limited liability shield operates.

Common law personal liability for commission of a tort, and the related Economic Loss Doctrine, are not well understood. The result can be practitioners who commit malpractice when advising clients who are starting a business, or bringing or defending against claims of personal liability with respect to LLC members or corporate shareholders. Business owners who are operating in the form of an LLC or a corporation may be complacent, thinking that, absent any intentional wrongdoing, they are insulated from personal liability by the limited liability shield.

#### *Brown v. Waldron*

The Trump and Jennings cases also demonstrate the power of proper factual pleading, buttressed by testimony and other evidence in the discovery phase of the litigation. However, parties may mistakenly rely solely on what are taught as the exceptions to limited liability: piercing the veil of limited liability, and signing a contract for an undisclosed or partially disclosed principal. Consider *Brown v. Waldron*<sup>91</sup>, which has facts similar to Jennings, but with a different outcome. Brown contracted with Waldren's LLC for the construction of a home, and

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<sup>89</sup> 487 S.E.2d 362 (GA App. 1997)

<sup>90</sup> *Id.* at 364

<sup>91</sup> *Brown v. Waldron*, 186 So. 3d 955 (Miss. Ct. App. 2016)

was unsatisfied with the workmanship. Waldren was the sole member of the LLC. Brown sued Waldren personally for negligence and breach of warranty.

The trial court ruled in Waldren's favor. The issue on appeal in the Brown case was whether Waldren could be held personally liable. Brown apparently advanced only piercing of the veil of limited liability and undisclosed principal/representational capacity arguments. The Court found both unpersuasive. With respect to the former, the court held:

The Browns contend they had no knowledge of WP's existence or that Waldron was an agent of WP.

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We are not persuaded by the Browns' argument. Although the Notice is signed by Waldron, all other documents in the record indicate that WP was the builder. This also includes the seller's disclosure statement, which was signed by the Browns. Although Shannon's deposition excerpt indicates the couple contacted Waldron using the number listed on the sign, she admittedly could not remember any other details. And according to Waldron, the sign he regularly used advertised the builder as "Waldron Properties LLC; Luxury Home Builder; Murray Waldron CPB." The phone number listed was for Waldron's cell phone. We recognize that the Browns indicated Waldron introduced himself as the builder. However, we cannot find that this one statement by Waldron indicated any intention on his part to hide that WP was actually the builder. This issue is without merit.<sup>92</sup>

With respect to the latter, the court held:

The courts have reserved piercing the veil of an LLC for "factual circumstances which are clearly extraordinary—where to do otherwise would 'subvert the ends of justice.'" *Gray*, 541 So.2d at 1046 (quoting *Johnson & Higgins of Miss., Inc. v. Comm'r of Ins.*, 321 So.2d 281, 284 (Miss.1975)). We do not find this case presents clearly extraordinary factual circumstances. The Browns did not enter into a contract with Waldron or WP, nor did they present credible evidence to indicate the contrary. Because the Browns failed to meet the first prong and are \*961 required to present credible evidence on each point, we decline to address the remaining two factors. This issue is without merit.<sup>93</sup>

When there are questions concerning workmanship, generally it would not be hard to find facts that would underpin a negligence claim. Further, in an LLC with a sole member, such as in the Brown case, it would virtually be a given that the member would have directly participated in carrying out the contract, such as construction of a home. Thus, an exception to the limited liability shield is virtually assured, which seems questionable at best. This, of course, assumes that plaintiff is aware of the exception to the limited liability shield for tortious conduct, which may not be the case.

Further, if only negligence were claimed, as opposed to intentional misconduct, it could very well be that the Economic Loss Doctrine would be a defense to the claim in a case similar to Brown because the only damage was to the home itself, which was the subject of the contract.

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<sup>92</sup> *Id.* at 960

<sup>93</sup> *Id.* at 960-61

However, this assumes first that the defendant understands the Economic Loss Doctrine, which also may not be the case.

Clearly, further education is warranted. A more widespread understanding of the Economic Loss Doctrine could be expected to shield LLC members and corporate shareholders from personal liability for alleged tortious conduct in more cases. On the other hand, a more widespread understanding that LLC members and corporate shareholders are personally liable for commission of a tort could be expected to lead to more claims of personal liability. This would exacerbate what already is an overly-broad, and arguably unfair, application of an exception to the limited liability shield, which isn't desirable. This suggests that consideration should be given to a reform of the limited liability shield. The situation that raises the most significant issue of unfairness involves cases where a contract is the basis of the relationship between the plaintiff and the entity, the plaintiff has only economic damages, and the member or manager is sued for ordinary negligence in what is really a breach of contract claim against the entity. In this situation, the limited liability shield could be expanded to limit liability to the entity, unless a member or shareholder engaged in intentional misconduct.

## CONCLUSION

John operates a CPA practice as a limited liability company. He is careful to ensure that he signs all engagement letters as an agent of the LLC, and separates his personal finances from that of the LLC. He commits negligence in performing an audit, which cost his client \$500,000 in damages. Because of financial issues, John had let his E & O insurance policy lapse. The LLC has a minimal value.

John is personally liable for the \$500,000 in damages because he committed a tort, i.e., malpractice. His LLC offers him no protection. LLC and corporate limited liability shields contain a carve out for the common law rule that imposes personal liability on a person who commits a tort. That John's LLC also will be liable under *Respondeat Superior* is irrelevant. An agent is liable for his own torts, even while carrying out his principal's business. Further, the client suing John will not have to plead or prove piercing of the veil of limited liability, or that John is personally liable on the contract due to a failure to disclose the legal identity of the LLC or his representational capacity. John's personal liability for commission of a tort is direct, and due to his individual acts and omissions. John also would gain no protection had his LLC been formed in Illinois because, while the standard limited liability shield in the Illinois LLC statute does not contain a carve out that allows for personal liability for commission of a tort, a carve out does exist for a member of an LLC who renders professional services. Finally, the Economic Loss Doctrine also will provide no defense to John because the doctrine does not bar tort claims where professional services by an accountant are involved, even though the plaintiff has suffered only economic damages. In short, John's LLC offers him no protection at all from personal liability based on a claim that he committed a tort, and his only defense will be to establish that he did not commit malpractice.

In other situations, opportunities to avoid personal liability may exist. Due to the peculiar language and history of the limited liability shield in the Illinois LLC statute, forming an LLC in Illinois offers an effective planning opportunity that can eliminate personal liability for commission of a tort, where professional services are not involved. The Illinois LLC, however, essentially provides a complete bar to personal liability for commission of a tort, outside of professional services, and thus raises questions of fairness to plaintiffs who have legitimate claims

of intentional wrongdoing by LLC members or corporate shareholders. The Illinois interpretation of the LLC limited liability shield, while questionable, has at least raised an important issue as to the scope of the exception to the limited liability shield for personal commission of a tort. The wide scope of the definition of professional services in Illinois does limit this planning opportunity.

In other cases, when disputes are based on an underlying contract with the LLC or corporation and involve only economic damages, the Economic Loss Doctrine can limit a third party to a breach of contract claim against the entity. Thus, the doctrine can represent an indirect, but effective, defense to tort claims that are brought against a member or shareholder personally. However, the doctrine contains myriad, and often conflicting, exceptions, making it a less than ideal defense in many cases. Because the doctrine also eliminates tort claims against the entity, as well as the member or shareholder, where it does apply, it raises questions of fairness to plaintiffs.

Finally, many business owners, and practitioners, may not be aware of this important exception to limited liability, shields, and related defenses. Failure to understand this area of law could jeopardize business owners, and amount to legal malpractice. Further education is warranted. However, personal liability for commission of a tort can amount to a wholesale exception to limited liability shields. Therefore, consideration should also be given to expanding limit liability shields. Where a contract is the basis of the relationship between the entity and the plaintiff, liability could be limited to the entity, unless a member or shareholder engaged in intentional misconduct.



## **DOING WHILE LEARNING: HOW BUSINESS PROGRAMS CAN INTEGRATE BENEFICIAL EXPERIENTIAL LEARNING OPPORTUNITIES FOR PRE-LAW BUSINESS STUDENTS**

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### **ABSTRACT**

*Experiential learning is at the forefront of pedagogical best practices in undergraduate education. Business schools, which are an increasingly popular choice for future law school applicants, should take steps to enrich the learning experience for these students. Many pre-law programs already implement and utilize successful experiential assignments which should be adopted by business schools. The skills learned in these assignments, which include contract simulations, mock trials, and client interviews, contain components that can benefit both the traditional business student and the law school applicant. By providing opportunities for experiential learning similar to their real-world counterparts, business schools can better position themselves to accommodate the needs of these students.*

### **INTRODUCTION**

The mission of many undergraduate legal studies or pre-law programs is to provide the skills and knowledge base to be successful in the legal profession. Pre-law programs make a conscious effort to incorporate student learning outcomes that are specifically tailored for the student aspiring to attend law school. Other undergraduate programs also boast a significant number of law school aspirants and programs with these pre-law students should be acutely aware of the expectations placed on law students. They must take measures to acclimate students to the rigors of their next academic endeavor, as they would with other post-graduate forms of education.

In recent years, law schools have made a noticeable shift away from an entirely lecture-oriented, traditional law school curriculum and towards an emphasis on experiential learning. The traditional approach focuses on the use of the case method to teach legal doctrine. In doing so, it reinforces the notion that students need to think logically and coherently within the bounds of the

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law.<sup>1</sup> Generally, law schools have relied on the time-tested Socratic Method to generate discussion, introspection, and analysis of cases to illuminate the legal principles found throughout the law. This variety of doctrinal teaching concentrates on identifying, understanding, applying, and critiquing the law in hypothetical settings.<sup>2</sup> Experiential learning, on the other hand, focuses on learning through real-life applications that simulate what the student will encounter in the field. Particularly, experiential learning projects known as high-impact practices (HIPs) efficiently maximize the learning environment.<sup>3</sup> For this reason, undergraduate programs should look to implement HIPs in their curricula that target skills needed for law school success.

Traditionally, business schools do not place a priority on training students for the specific rigors of law school.<sup>4</sup> However, more students are choosing an undergraduate business degree as the preferred field of study prior to applying for law school.<sup>5</sup> The sheer number of future law school applicants enrolled in business programs nationwide suggest that their needs should be addressed at some point in the curriculum. It would be unwise for business programs, presumably seeking to grow and expand their student population, to simply ignore the specific skills needed for law school success. Business schools seeking to accommodate the precise learning needs of their pre-law students should design law courses to provide a foundation for the student's first-year of law school. The most fundamental courses in a pre-law student's business curriculum are the Legal Environment of Business or Business Law courses. It is through these courses that business programs can ideally introduce experiential learning concepts used in legal studies programs.

Notably, experiential learning course modules with a pre-law emphasis need not be implemented at the expense of traditional business students; rather, these course artifacts can be integrated within the business law course to prepare pre-law students, while simultaneously providing business students with a wider and more hands-on view of the legal environment within which they will work. For example, a contract negotiation simulation may be more relevant for students planning on becoming attorneys, but business professionals also need to be aware of the process of contract formation to understand how and why compromises are critical for the creation of binding business agreements. And, of course, many businesspersons prefer to negotiate and draft contracts without the assistance of a lawyer. In theory, such practice will help those students as much as pre-law students.

In other words, including such projects will "kill two birds with one stone," and create a learning environment that is richer and more effective. While one or two law business law courses cannot include the depth of pre-law instruction provided by an entire legal studies curriculum, business law professors can and should borrow course components to augment all students'

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<sup>1</sup>Emily Traylor Vande Lune, *Settling for Six: Should the American Bar Association Have Done More to Promote Experiential Learning in Law Schools?*, 39 J. LEGAL PROF. 305 (2015).

<sup>2</sup>Martin J. Katz, *Teaching Professional Identity in Law School*, 42 COLO. LAW. 45 (2013).

<sup>3</sup>George Kuh, *High Impact Educational Practices: What They Are, Who Has Access to Them, and Why They Matter* 24, ASSOCIATION OF AMERICAN COLLEGES AND UNIVERSITIES (2008).

<sup>4</sup>A small sampling of business school missions illustrate this point. See George Mason University School of Business, *Mission Statement*, <http://business.gmu.edu/our-school/mission-statement/>, (last visited May 14, 2016) (stating that success in a global business environment is critical); Temple University Fox School of Business, *Vision and Mission*, [http://www.fox.temple.edu/cms\\_about-fox/mission/](http://www.fox.temple.edu/cms_about-fox/mission/), (last visited May 14, 2016) (emphasizing professional development and entrepreneurial ideas); Rutgers Business School, *Welcome to Rutgers Business School*, <http://www.business.rutgers.edu/about-rbs/welcome>, (last visited May 14, 2016) (stating its mission is to cultivate business knowledge and to partner with businesses across diverse communities).

<sup>5</sup>LAWSCHOOLI, *Best Majors for Law School*, <https://lawschooli.com/best-majors-for-law-school/> (last visited May 14, 2016) (noting that over 4,600 business management majors, 1,900 business administration majors, 3,000 economics majors and 1,400 accounting majors applied to law school in 2007).

understanding of the legal system. The cornerstone of a quality legal studies program, and an element that business law professors should mimic, is the integrated use within individual courses of experiential learning targeted towards skills needed for the practice of law. To comprehend how to systematically include experiential learning to its audience of future law school entrants, all undergraduate programs should examine the expectations set by law schools.

Part I of this article discusses the importance of including experiential learning in any well-crafted university curriculum. Part II explains why business programs should look to replicate the experiential learning opportunities traditionally offered by legal studies programs as a way to accommodate the growing number of pre-law business students. These program artifacts employ student learning outcomes that can be beneficially applied to all business students, in addition to being particularly relevant to pre-law students. Part III discusses three experiential learning projects that should specifically be adopted in business curricula, including detailed examples of a contract simulation (Appendices A-C) and client interview exercise (Appendix D).

### I. EXPERIENTIAL LEARNING LEADS TO STUDENT SUCCESS

Described as the “hottest buzzword in legal education today,” experiential learning focuses on the actual practice of law rather than simply studying it.<sup>6</sup> The Clinical Legal Education Association has defined “experiential learning” as the integration of “theory and practice by combining academic inquiry with actual experience.”<sup>7</sup> In the law school setting, this entails educational practices such as observing lawyers or impersonating them in simulated or actual legal scenarios.<sup>8</sup> Experiential learning of this nature should not be relegated to stand-alone courses taught in a vacuum; rather this method of learning should be integrated throughout the curriculum and eventually be positioned side-by-side with the case dialogue approach in traditional doctrinal courses.<sup>9</sup> Without question, experiential learning is needed to “strengthen basic lawyering skills, foster a sense of professional identity and create the ability to learn from self-reflection and feedback.”<sup>10</sup> True experiential learning involves not only the experience of role-playing, but also reflection and extrapolation to other legal settings.<sup>11</sup>

Some law schools have initiated a tidal wave of change, while others are taking a more measured, gradual approach. Either way, what is clear is that the traditional model is being modified to include the integration of experiential learning throughout the three years of law school.<sup>12</sup> Critics note a major flaw of the traditional approach is that even if new lawyers know the law, they do not know how to be lawyers.<sup>13</sup> Experiential learning is designed to ameliorate this flaw by teaching students how to be lawyers. The practice of law involves far more than the ability to have an encyclopedic inventory of various rules and statutes. Practicing law more often involves

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<sup>6</sup>Michele Mekel, *Putting Theory Into Practice: Thoughts from the Trenches on Developing a Doctrinally Integrated Semester-in-Practice Program in Health Law and Policy*, 9 IND. HEALTH L. REV. 503 (2012).

<sup>7</sup>Roy Stuckey, *Best Practices in Legal Education* 165 (2007).

<sup>8</sup>*Id.*

<sup>9</sup>William Sullivan, et al, *Educating Lawyers: Preparation for the Profession of Law*, CARNEGIE FOUNDATION FOR THE ADVANCEMENT OF TEACHING 9 (2007).

<sup>10</sup>Vande Lune, *supra* note 1, at 309.

<sup>11</sup>Stuckey, *supra* note 7, at 166.

<sup>12</sup>Martin J. Katz, *Facilitating Better Law Teaching –NOW*, 62 EMORY L.J. 823, 829 (2013) (noting that while many law schools have increased clinical and field experience opportunities in the recent past, other law school remain slow to implement experiential learning options curriculum-wide).

<sup>13</sup>*Id.*

interviewing clients, questioning witnesses, managing and fostering relationships with opposing counsel, and negotiation skills. Employers have observed that students who have had experiential learning courses are better suited for the complexities of the practice of law.<sup>14</sup>

The literature is replete with support for the benefits of experiential learning. As one scholar noted, “Students do not acquire this deep understanding of the law through passive means of instruction. Students learn by experiencing, and doctrine is no exception.”<sup>15</sup> Experiential learning is not a novelty to only be utilized in discrete classes while maintaining the status quo throughout the rest of the curriculum. Indeed, scholars have noted that experiential learning is the best way to teach all material in law schools.<sup>16</sup>

Experiential learning has a scientific basis for its claim that it is the preferred style of learning. On a physiological level, cognitive scientists have produced research showing that students who are active in the learning environment learn better than those who are not.<sup>17</sup> Experiential learning has other benefits beyond simply the ability to retain the material in the course. For example, experiential learning has been shown to improve motivation and attitudes, as well as the willingness to actively participate during class lectures.<sup>18</sup>

At the undergraduate level, public universities face increasing pressure to meet legislative mandates to produce measureable outcomes. Among others, these outcomes include demonstrating that students are career ready upon graduation. They also include improving student retention rates, as well as persistence and time to degree. More specifically, recent research by George Kuh and others has shown that infusing experiential learning opportunities called HIPs into the undergraduate curriculum can positively impact these outcomes.<sup>19</sup> Examples of HIPs for pre-law students include internships, mock or moot court simulations, or pro bono work within the community.<sup>20</sup> The other benefits of active learning projects such as HIPs include fostering deeper connections between students and faculty, enhanced student engagement, and more satisfaction with the overall college experience for students.<sup>21</sup> Indeed one of the most important factors leading to the success of college students is student engagement.<sup>22</sup>

Kuh identified several categories of high impact educational practices.<sup>23</sup> In addition to defining the categories of HIPs, Kuh discussed the essential qualities that all HIPs must have to make them truly high impact for students. These include requirements such as an effortful educational activity, high expectations from faculty, frequent and meaningful feedback from

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<sup>14</sup>Katz, *supra* note 2, at 47.

<sup>15</sup>Jessica Erickson, *Experiential Education in the Lecture Hall*, 6 NE. U. L.J. 87, 88 (2013).

<sup>16</sup>*Id.* at 88. Erickson aptly summarizes this concept by arguing that, “A student who has memorized the rules but who cannot apply them in these ways does not know the law in any satisfactory way.” *Id.*

<sup>17</sup>George Kuh, et al, *What Matters to Student Success: A Review of the Literature*, NATIONAL POSTSECONDARY EDUCATIONAL COOPERATIVE 86 (2006).

<sup>18</sup>Stuckey, *supra* note 7, at 167.

<sup>19</sup>Kuh, *supra* note 3, at 15-17.

<sup>20</sup>Carole Silver, et al, *Gaining from the System: Lessons from the Law School Survey of Student Engagement About Student Development in Law School*, 10 U. ST. THOMAS L.J. 286, 302 (2012).

<sup>21</sup>Kuh, *supra* note 17, at 8.

<sup>22</sup>*Id.*

<sup>23</sup>Kuh, *supra* note 3, at 19-21. These categories include first-year seminars, common intellectual experiences, learning communities, writing-intensive courses, collaborative assignments, undergraduate research, diversity or global learning, service learning, capstone courses, and internships. Notably, the experiential learning assignments advocated in this article all fall in one of Kuh’s categories. The contract simulation and mock trial are collaborative assignments, whereas the client interview contains elements of both collaboration and diversity learning.

faculty, and critical reflection by students on the learning experience.<sup>24</sup> Researchers have found that repeated student engagement is an indicator of an educational practice that positively impact students.<sup>25</sup>

Business programs have become adept at including appropriate HIPs to offer targeted experiential learning. One HIP that many business programs are increasingly utilizing are study abroad opportunities.<sup>26</sup> Kuh included study abroad as one of the major categories of HIPs, but recognized that many students are not able to participate in these activities, including minority students and first generation college students.<sup>27</sup> Some researchers have found that longer study abroad experiences have more impact on students, but even relatively short term study abroad experiences can benefit students by improving their cross-cultural competencies and may make the study abroad experience more attainable for those under-represented students who could not typically devote a full semester to study abroad.<sup>28</sup> In order for a study abroad activity to impact students positively, it should be well-designed as an immersive educational experience. Many short term study abroad programs can be as short as two weeks, and they can be discipline specific and faculty-led and tied to courses for academic credit.

Faculty involved in planning the trip can design activities that give students meaningful opportunities to study a different or comparative approach to an area like the legal system or business climate. Given the prospect of an intense and rich learning environment targeted towards specific student learning outcomes, study abroad opportunities rightfully belong in the business curriculum. Particularly, those students who have studied abroad will have a unique advantage in increasingly global workplaces.<sup>29</sup> Experiential learning is no stranger to business programs, and opportunities to expand experiential learning within the curriculum should be wholeheartedly embraced.

Experiential learning should be the vehicle by which professors ensure that student learning outcomes are met rather than a parallel route to achieve those learning outcomes. The Socratic Method may have its place in the legal academy, but its intrinsically passive nature inhibits students' ability to actually absorb information meaningfully.<sup>30</sup> At the end of the day, students who learn through experiential learning have a greater chance of understanding the material. While this might have real-world effects on bar passage rates, the greater benefit is that the aforementioned transition from law student to attorney is much smoother, less stressful, and decreases the risk of serious malpractice due to incompetence.

## II. THE INTERSECTION OF LAW SCHOOL, LEGAL STUDIES, AND BUSINESS PROGRAMS

In order for undergraduate programs to fully ascertain how to cater to the pre-law student, an understanding of the pedagogical approach to law school is necessary. Experts now stress the need for "practice-ready" attorneys who know more than just legal theory upon completion of law

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<sup>24</sup>*Id.* at 39.

<sup>25</sup>Kuh, *supra* note 17, at 32-40.

<sup>26</sup>Adrien Presley, et al, *A Study of Business Student Choice to Study Abroad: A Test of the Theory of Planned Behavior*, 21 J. TEACHING INT'L. BUS. 227, 228 (2010).

<sup>27</sup>Kuh, *supra* note 3, at 25-26.

<sup>28</sup>Mary Dwyer, *More Is Better: The Impact of Study Abroad Program Duration*, 10 INTERDISCIPLINARY J. STUDY ABROAD 151, 161 (2004).

<sup>29</sup>Tracy Williams, *Exploring the Impact of Study Abroad on Students' Intercultural Communication Skills: Adaptability and Sensitivity*, 9 J. STUDIES INT'L. EDUC. 356, 368 (2005).

<sup>30</sup>Erickson, *supra* note 15, at 94.

school.<sup>31</sup> Legal studies programs and business schools both have a vested interest in producing students who are well-prepared for entering law school. It would be wise for undergraduate programs to incorporate skills that will be necessary for law school success. This includes experiential learning.

The impetus behind the move by law schools to experiential learning is due in part to the influential Carnegie Report promulgated in 2007.<sup>32</sup> This report reinforced the notion that thinking and performing like a lawyer are two disparate skills, and in light of this, law schools need to emphasize skills designed to promote the visibility and importance of practical lawyering.<sup>33</sup> The report noted the dearth of lawyering skills, particularly within the first year of law school, and recommended law schools depart from solely relying on doctrinal analysis.<sup>34</sup> Further, the Report observed that legal doctrine is just one facet of a law school's tripartite curricular goals.<sup>35</sup> The other two curricular goals – acting with responsibility for clients and professional identity and values – are just as crucial to the legal education of lawyers as they are to graduates of business schools.<sup>36</sup>

A more recent stimulus for change is the new American Bar Association accreditation standards that place specific, concrete requirements for experiential learning within law schools. Adopted in 2014 and effective in the fall of 2016, Accreditation Standard 303, for the first time, requires a minimum number of experiential courses within all law school curricula.<sup>37</sup> In order to maintain critical ABA accreditation, Standard 303 requires a minimum of six hours of “experiential courses” be placed within the law school's curriculum. In order to qualify as an experiential course, the course must do four things: (1) integrate doctrine into professional skills, (2) develop concepts underlying professional skills, (3) provide multiple opportunities for performance, and (4) provide opportunities for self-evaluation.<sup>38</sup>

Further, Standard 303 mandates that the experiential course fall into one of three categories: (1) A simulation course, (2) A law clinic, or (3) A field placement.<sup>39</sup> Simulations are less costly and less risky given that no real client interests are being affected. Standard 304 defines a simulation as one that requires the student to act as a lawyer representing a hypothetical client in some fictional scenario presented by the instructor.<sup>40</sup> A law clinic, on the other hand, involves the advising or representing of actual clients<sup>41</sup>. However, the ABA standard does not prioritize one form over the other, so long as the curriculum includes at least six hours of any of the three kinds of experiential learning.

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<sup>31</sup>See generally Timothy Storm, *Chair's Column: Developing “Practice-Ready” Lawyers*, ILLINOIS STATE BAR ASSOCIATION, (October 2011), <http://www.isba.org/sections/generalpractice/newsletter/2011/10/chairscolumndevelopingpracticeready>.

<sup>32</sup>Sullivan, *supra* note 9.

<sup>33</sup>*Id.* at 9.

<sup>34</sup>*Id.* at 4.

<sup>35</sup>*Id.* at 8.

<sup>36</sup>*Id.*

<sup>37</sup>Vande Lune, *supra* note 1, at 309. (observing that the prior standard vaguely required law schools to “offer substantial opportunities for . . . real-life practice experiences” without mandating any real benchmarks.) *Id.* at 307. This new standard does exactly that.

<sup>38</sup>See THE AMERICAN BAR ASSOCIATION'S ACCREDITATION STANDARDS, found at [http://www.americanbar.org/groups/legal\\_education/resources/standards.html](http://www.americanbar.org/groups/legal_education/resources/standards.html) (last visited May 14, 2016).

<sup>39</sup>*Id.*

<sup>40</sup>*Id.*

<sup>41</sup>Indeed, the unauthorized practice of law is a felony in many states when a non-lawyer advises or represents clients in legal matters. See generally FLA. STAT. § 454.23 (2016).

This move by the ABA will certainly catalyze the speed at which law schools move towards experiential learning. Currently, many law schools are moving at a glacial velocity.<sup>42</sup> The ABA, as an external motivator, will likely quicken the pace of these reforms that scholars have noted are essential for legal education. While this is certainly just an incremental move, the ABA has signaled its displeasure with schools refusing to make the move on its own. As a result, it is apparent that the move towards experiential learning in law schools is here to stay.

It is important to note that, although the ABA created only broad categories of experiential learning, opportunities for practical learning take many forms. Experiential learning does not, however, include part-time employment in law settings because the learning is not (as it must be) accompanied with some kind of academic inquiry.<sup>43</sup> Instead, experiential learning involves direct supervision from a professor, in real-time, that goes along with the practical experience. For example, the University of California, Irvine requires a six-credit, year-long course in “Lawyering Skills” that focuses on interviewing skills with clients.<sup>44</sup> UCI also requires a first year class named “Legal Profession” that does more than simply require students to memorize by rote the Rules of Professional Conduct. Instead, students use simulation exercises (one of the ABA-approved categories) to illustrate ethical dilemmas in the legal profession.<sup>45</sup>

Other potential uses for experiential learning go beyond the traditional litigation-focused doctrinal course. Therefore, a course in contracts (which has a strong transactional element) might have assignments devoted to drafting or negotiating simulated contracts.<sup>46</sup> Or, other scholars have proposed a three-year experiential legal writing class that requires students to interview clients, argue motions, and consult with partners before writing legal briefs or memoranda.<sup>47</sup> Finally, Loyola University New Orleans College of Law has experimented with a study-abroad course in Turkey and Greece to focus on specific international legal experiences.<sup>48</sup> Although each of these activities differs, the pedagogical goals of each are basically the same: to provide an educational experience that develops essential qualities needed in the workforce by integrating theory with practice.

How does the transition towards experiential learning in law schools affect the mission or goals of business programs? Students will benefit from being exposed to the skills, content, and knowledge required in law schools, as these students will not only be better equipped to cognitively assimilate the information, but will also have a comparative advantage over those students without

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<sup>42</sup>Katz, *supra* note 12, at 829. *See also* Robert Kuehn, *Pricing Clinical Legal Education*, 92 DENVER U.L. REV. 2, 37 (2014) (noting that only 22 law schools require a clinic or externship). On the other hand, Parker and Schechter observed that 30 percent of all ABA-approved law schools do offer field placement opportunities, suggesting that experiential learning may not be as rare as has been otherwise suggested by others. Parker, Robert A. and Schechter, Sue, *The Ugly Duckling Comes of Age: The Promise of Full-Time Field Placements* (July 15, 2011), <http://ssrn.com/abstract=1886509> or <http://dx.doi.org/10.2139/ssrn.1886509>.

<sup>43</sup>Roy Stuckey, *Teaching with Purpose: Defining and Achieving Desired Outcomes in Clinical Law Courses*, 13 CLINICAL L. REV. 807, 812 (2007).

<sup>44</sup>Carrie Hempel, *Writing on a Blank Slate: Creating a Blueprint for Experiential Learning at the University of California, Irvine School of Law*, 1 UC IRVINE L. REV. 147, 150 (2011). *See also* Katz, *supra* note 2, at 46 (noting that a similar course is offered by the University of Denver’s College of Law called “Lawyering Process”, which is also offered year-round in the first year of law school).

<sup>45</sup>*Id.* at 150-51.

<sup>46</sup>*See* David Getches, *What’s New in Legal Education – Experiential Learning*, 38 APR COLO. LAW. 13 (2009).

<sup>47</sup>Adam Lamparello and Charles MacLean, *A Proposal to the ABA: Integrating Legal Writing and Experiential Learning into a Required Six-Semester Curriculum that Trains Students in Core Competencies, ‘Soft Skills’, and Real-World Judgment*. 43 CAP. U. L. REV. 59 (2015).

<sup>48</sup>Patrick Hugg and Kathryn Lorio, *Experiential Teaching on Steroids: Unexpected Pedagogical Discoveries*. 15 LOY. J. PUB. INT’L. L. 195, 210 (2013).

this kind of instruction. Business schools currently utilize experiential learning opportunities, but those may not be focused on skills needed for law school success.<sup>49</sup> So, undergraduate business programs should be keenly attuned to the foci and curricula of law schools and should vigorously attempt to align their own student learning outcomes and modes of instruction with those of law schools.

Specifically, a sample of mission statements from U.S. undergraduate legal studies programs illustrates concepts that could just as easily be translated to a business program. Quinnipiac University offers a BA in legal studies that focuses on developing thinking and writing skills for the legal professional.<sup>50</sup> Their legal studies mission statement states, “Our students are often interested in continuing with their education. Many graduates go directly to law school; others work for a year or two before applying.”<sup>51</sup> Similarly, the BS in legal studies from Roger Williams University emphasizes critical thinking and legal reasoning skills.<sup>52</sup> The mission statement for that program provides, “The Legal Studies program also provides students with the kind of analytical skills, writing proficiency, and academic discipline necessary to future success in law school.” Finally, the mission statement for the legal studies program at the University of West Florida takes a similar approach to preparation for law school education by selectively concentrating on “provid[ing] a foundation for law school.”<sup>53</sup> While not making business law its main mission, business programs could certainly incorporate law in general as a part of their mission statements as a way to accommodate pre-law students.

Undergraduate business programs have already begun the process of incorporating legal-based experiential learning in their courses. The accreditation standards for the Association to Advance Collegiate Schools of Business identifies business law as one of the core traditional business subjects crucial to the overall business curricula.<sup>54</sup> Business law courses are ideal to include these types of learning projects. Georgia State University’s College of Business requires students to take a course in the Legal and Ethical Environment of Business.<sup>55</sup> As a component of the course, students must complete a “Business Court Project” that demands students attend an actual court proceeding and then reflect on their observations.<sup>56</sup> Another scholar noted the value of moot court, or appellate simulations, within business law classes as a way expose students to

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<sup>49</sup>See generally Debra Burke, *Service Learning: Opportunities for Legal Studies in Business*, 24 J. LEGAL STUD. EDUC. 129, 156 (2007) (noting that service learning is an important kind of experiential learning that can boost civic responsibility for students, but may have some limitations in the legal field due to statutory unauthorized practice of law issues); Claudia Hart, et al, *Experiential, Collaborative and Team Projects: Communication Audits in the MBA Communication Course*, 8 AM. J. OF BUS. EDUC. 289 (2015) (noting that that service-learning projects are invaluable tools to teach marketable business skills that are attractive to future employers).

<sup>50</sup>Quinnipiac University, *Department of Legal Studies*, <https://www.quinnipiac.edu/college-of-arts-and-sciences/department-of-legal-studies/ba-in-legal-studies/>, (last visited May 3, 2016).

<sup>51</sup>*Id.*

<sup>52</sup>Roger Williams University, *Legal Studies*, <http://www.rwu.edu/academics/schools-colleges/sjs/degree-offerings/legal-studies/undergraduate/>, (last visited May 3, 2016).

<sup>53</sup>University of West Florida, *Legal Studies*, <http://catalog.uwf.edu/undergraduate/legalstudies/>, (last visited May 23, 2016).

<sup>54</sup>ASSOCIATION TO ADVANCE COLLEGIATE SCHOOLS OF BUSINESS, *Eligibility Procedures and Accreditation Standards for Business Accreditation* 9 (2013), <http://www.aacsb.edu/~media/AACSB/Docs/Accreditation/Standards/2013-bus-standards-update.ashx> (last visited May 23, 2016).

<sup>55</sup>Anne Nees, et al, *Enhancing the Educational Value of Experiential Learning: The Business Court Project*. 27 J. LEGAL STUD. EDUC. 171, 208 (2010).

<sup>56</sup>*Id.* at 176.

the intricacies of a well-defined and narrow issue.<sup>57</sup> These are only isolated examples, however, and a much more systematic inclusion of legal-based experiential courses is crucial to augmenting pre-law instruction.

### III. TRANSFERRABLE EXPERIENTIAL OPPORTUNITIES

A wide variety of experiential learning projects or HIPs are available to cater to the pre-law student. Experiential learning opportunities can arise both from within assigned coursework and from pre-law university organizations and community partnerships. The institution can determine on its own whether the course artifact should be required as part of the core curriculum, but what is important is to ensure that pre-law business students have the option to take advantage of these even as electives. Faculty should actively encourage students to take advantage of all of the possibilities offered by the program. Three distinct items can be easily assimilated into business programs. They are:

- 1 – Contract Simulations
- 2 – Mock Trial Competitions
- 3 – Client Interviews

While other opportunities for experiential learning should be pursued, these three offer great returns on investment, given that all business students can benefit from these regardless of their intent to pursue a career in law. Contract simulations and client interviews allow business students to practice interpersonal interactions that are vital to business success, while mock trials provide students the opportunity to practice forming cogent and logical arguments.

#### A. CONTRACT SIMULATION

While it is common for legal studies curricula to contain self-contained classes on Contracts, business law courses also cover contractual formation and remedies for breach in great detail.<sup>58</sup> This creates a learning environment where a contract simulation is an ideal method of experiential learning and allows future business leaders and pre-law students to obtain valuable experience in the process of drafting a contract. Contract simulations afford the instructor the opportunity to assess two distinct skills – oral advocacy in the form of negotiation and written communication in the form of the draft contract. Both of these skills are of paramount importance in a traditional business law course.

Of course, contract simulations are not inherently a creature of pre-law or legal studies programs. Scholars have previously noted that contract simulations are useful in business law

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<sup>57</sup>William McDevitt, *Active Learning through Appellate Simulation: A Simple Recipe for a Business Law Course*, 26 J. LEGAL STUD. EDUC. 245, 262 (2009). Although McDevitt's article involves business students not necessarily planning to choose law as an ultimate career, the same rationale would apply to pre-law business students.

<sup>58</sup>See generally University of West Florida, *University Catalog*, <http://catalog.uwf.edu/courseinformation/courses/bul/> (last visited May 3, 2016) (BUL 3130 Business Law covers "contracts" and "sales under the Uniform Commercial Code"); Rutgers University, *Course Descriptions*, <http://www.business.rutgers.edu/current-students/undergrad-newark/academics/courses/> (last visited May 3, 2016) (Business Law II covers "contract law"); University of Texas-San Antonio, *Business Law (BLW) Courses*, <http://catalog.utsa.edu/undergraduate/coursedescriptions/blw/> (last visited May 3, 2016) (BLW 3013 covers "contracts" and the "Uniform Commercial Code").

courses to increase exposure to problem-based learning.<sup>59</sup> Marsnik and Thompson, justifiably, placed emphasis on the need to develop business skills as the impetus behind including this type of exercise.<sup>60</sup> Considering the number of pre-law students in business law courses, a greater weight can be put on the legal terminology within the document.<sup>61</sup> As Professor Robson notes, an understanding of legal, boilerplate language is crucial to effective contract drafting.<sup>62</sup> The strategic difference that this article proposes is that a greater focus can and must be placed on the role of the attorney and business leader in deciphering legal terminology to proactively resolve potential future litigation. While the terms of the deal are certainly important, items such as assignment or severability clauses should not be “thrown in” merely because a form found on the Internet contains them. The ability to critically examine the need to employ a severability clause, for example, allows the student to analytically work through the legal ramifications of each and every part of the contract. Some scholars have noted that the emphasis on legal methodology should differ based upon if the class is a law course or a non-law course; however, this article proposes that no such differentiation is necessary.<sup>63</sup> Furthermore, Bruce Klaw has argued for the dismissal of pre-law elements in contract simulations, arguing that business students are not future lawyers.<sup>64</sup> This article takes the opposing view – the number of pre-law business students indicates that business program are in fact training significant numbers of future lawyers.<sup>65</sup>

A contract simulation allows students to negotiate and then memorialize the agreement in writing. Before the assignment begins, an instructor should give guidance on contract style and format, giving tips such as avoiding legalese, opening the contract with basic recitals, and using headings as a way to logically organize the individual clauses within the contract.<sup>66</sup> After the instructor has prepared the class on the fundamentals of contract drafting, the students should proceed with the in-class portion of the assignment.

Quite simply, the work completed in the classroom setting is vital to the success of the assignment. Students are divided into partnerships and are given a description of their client’s demands for completion of the contract. Each partnership is grouped with an opposing partnership to form the contract group. The contract assignment requires students to negotiate up to ten clauses, and each side is told how important each clause is to that client.<sup>67</sup> The importance of the clauses ranges from “low” to “medium” to “high” importance.” This takes into account that real-world clients have different demands for different clauses. Some items are indispensable, while others

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<sup>59</sup>Susan Marsnik & Dale Thompson, *Using Contract Negotiation Exercises to Develop Higher Order Thinking and Strategic Business Skills*, 30 J. LEGAL STUD. EDUC. 201 (2013); Mary Anne Nixon & Edward Brayton, *The Contractor’s Contract: A Tool for Developing Critical Thinking Skills*, 12 J. LEGAL STUD. EDUC. 220 (1994); Regina Robson, *An Entrepreneurial Stand in the Business Law Course: The Ice Cream Project*, 26 J. LEGAL STUD. EDUC. 433 (2009); Larry DiMatteo & T. Leigh Anenson, *Teaching Law and Theory Through Context: Contract Clauses in Legal Studies Education*, 24 J. LEGAL STUD. EDUC. 19 (2007).

<sup>60</sup>*Id.* For example, Marsnik and Thompson caution instructors to forego requiring liquidated damages clauses if that area of the law is not ordinarily covered in class. Liquidated damages, of course, are an important consideration for any attorney drafting a contract.

<sup>61</sup>*See supra* note 5 for the pre-law enrollment numbers in business programs.

<sup>62</sup>Robson, *supra* note 59, at 438.

<sup>63</sup>Susan Denbo, *Contracts in the Classroom – Providing Undergraduate Business Students with Important “Real Life” Skills*, 22 J. LEGAL STUD. EDUC. 149, 156 (2005).

<sup>64</sup>Bruce Klaw, *Deal Making 2.0: A New Experiential Simulation in Contract Negotiation and Drafting for Business Students in the Global and Digital Age*, 33 J. LEGAL STUD. EDUC. 37, 28 (2016).

<sup>65</sup>*See supra*, note 5.

<sup>66</sup>*See infra* Appendix A for an example of common instructions for contract formation.

<sup>67</sup>*See infra* Appendix B & C for an example of a contract simulation exercise.

are luxuries that are not “deal breakers.” Neither team knows the demands of the other side. The instructor should observe the students in class and be present to offer a mediated approach should the students reach an impasse. At least two full class days should be allocated to the experiential aspect of this assignment, with the first day devoted to the negotiation process and the second day covering drafting the contract itself.

During that first class, the groups are adversaries and attempt to gain the best possible contract for their clients within the constraints of ethics and professionalism. It should be stressed that this is not a “war”; both hypothetical clients want a deal to be completed, and it is critical that each side bargain in good faith. Unreasonably failing to bargain in an attempt to wage a war of attrition cannot be tolerated and the instructor must address this situation with the groups, should it arise. Students must understand that in order to gain a beneficial concession, something must be given up in return. Engaged students quickly realize that the process of negotiation takes several proposals and counterproposals before a final deal is reached. Ideally, the first day of the assignment should fall on the last day of the week to allow students to continue the negotiation process over a weekend.

This approach requires students to do much of the work outside of class and be fully prepared on the details of the contract before negotiating and drafting in class. Also known as a “flipped classroom,” this kind of project has several key advantages, including freeing up valuable class time to focus on the contract.<sup>68</sup> It also allows students to avoid distractions commonly seen during traditional lectures.<sup>69</sup> The instructor should not lecture or review, in class, the details of the contractual terms themselves. Students must be expected to familiarize themselves with the prospective deal and their client’s demands as a pre-requisite to negotiating in class. This approach differs from the simulation recommended by other scholars, where most, if not all, of the work is done outside of class.<sup>70</sup> Flipping the classroom maximizes the benefits from the experiential project and allows the instructor to maintain a hands-on approach to immediately ameliorate or mediate any confusion or dispute.

Once a deal is struck, the dynamics of the four-person group must dramatically change. The teams must switch from an adversarial to a collaborative role and drafting the contract in line with the terms of their oral agreement. The second class date allows the teams to discuss general themes of contract drafting and give the instructor the opportunity to dispel any general misconceptions from the outset. After this class period ends, students are expected to take what they have learned and craft a clear and coherent document that unambiguously outlines the terms of the deal reached. Students should be given at least two weeks to work outside of class to draft the contract. Once the draft is submitted, a reflective paper should be assigned that, in accordance with experiential learning theory, allows the student to assimilate what is learned. The reflective paper can also fulfill a more pragmatic goal: getting a sense of each student’s level of active participation in the assignment.

Students quickly realize that there is a reason standard form contracts frequently run multiple pages, and even the most unassuming of residential lease agreements can extend to five or six pages in length. Students gain a greater appreciation for the need to eliminate ambiguity and loopholes by doing a contract simulation rather than simply viewing form contracts. Contract

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<sup>68</sup>Tanya Marcum & Sandra Perry, *Flips and Flops: A New Approach to a Traditional Law Course*, 32 J. LEGAL STUD. EDUC. 255, 256-57 (2015).

<sup>69</sup>*Id.* at 256-58. Specifically, Marcum and Perry note the applicability of a flipped classroom model to an undergraduate Legal Environment of Business course. *Id.*

<sup>70</sup>Marsnik, *supra* note 59; Robson, *supra* note 59; Denbo, *supra* note 63.

simulations improve critical thinking skills by becoming engaged in the law.<sup>71</sup> It is the “doing” that enriches the understanding of contract drafting. This element cannot be replicated with a standard instructor’s lecture. This kind of experiential learning simulation also illustrates that interpersonal skills can be just as valuable, if not more so, than knowing the doctrinal rules of contracts.

### B. MOCK TRIAL

Numerous researchers have explored the use of a mock trial as an effective pedagogical tool to help students improve critical thinking and to enhance their interest in their class materials.<sup>72</sup> Many undergraduate institutions offer students the opportunity to participate in an organized mock trial team experience outside of the classroom or as a co-curricular activity. The American Mock Trial Association (AMTA) governs intercollegiate mock trial competitions across the country. There are now over 400 universities who have organized mock trial teams that participate in AMTA tournaments.<sup>73</sup> AMTA asserts that participation in mock trial increases a student’s critical thinking skills, public speaking ability, and knowledge of court processes and rules.<sup>74</sup> At some universities, the interest generated by having a mock trial team has helped to revitalize student interest in pre-law academic disciplines.<sup>75</sup> For business programs seeking to capitalize on pre-law interest within the program, mock trial competitions provide an excellent outlet for experiential learning.

An AMTA mock trial team is open to all undergraduate students who are in good academic standing. As expected, the team generally attracts pre-law students who are anticipating gaining important skills that will serve them well in law school. While mock trial teams are routinely sponsored by legal studies programs, business schools can and should take a major role in organizing a team. Courtroom simulations are well suited to convey business law principles to students.<sup>76</sup> In courtroom simulations, students learn to construct arguments and are able to appreciate the complicated process of litigation adjudication from a range of perspectives.<sup>77</sup> The experience of exploring a contentious legal issue is valuable for both the pre-law and business student and thus is a perfect kind of experiential learning opportunity in a well-organized business program.<sup>78</sup>

Under Kuh’s categories of HIPs, a mock trial qualifies as a collaborative assignment or project. As described by Kuh, collaborative learning includes two primary goals: “learning to work and solve problems in the company of others, and sharpening one’s own understanding by listening

<sup>71</sup>Klaw, *supra* note 64, at 41.

<sup>72</sup>Kevin Farmer, et al, *The Mock Trial: A Dynamic Exercise for Thinking Critically About Management Theories, Topics, and Practices*, J. OF MGMT. EDUC., 1-31 (2012); Lewis Ringel, *Designing a Moot Court: What to Do, What Not to Do, and Suggestions for How to Do It*, 37 POLITICAL SCIENCE AND POLITICS 459-65 (2004); Dean Spader, *Two Models and Three Uses for Mock Trials in Justice Education*, 13 J. CRIMINAL JUSTICE EDUC. 57-86 (2002); Meg Karraker, *Mock Trials and Critical Thinking*, 41 COLLEGE TEACHING 134-37 (1993).

<sup>73</sup>AMERICAN MOCK TRIAL ASSOCIATION, *AMTA Member Schools*, <http://www.collegemocktrial.org/about-ama/member-schools/> (last visited May 3, 2016).

<sup>74</sup>See AMERICAN MOCK TRIAL ASSOCIATION, *History of AMTA*, <http://www.collegemocktrial.org/about-ama/history/> (last visited May 3, 2016).

<sup>75</sup>John Vile & Thomas Van Dervort, *Revitalizing Undergraduate Programs Through Intercollegiate Mock Trial Competition*, 27 J. CRIMINAL JUSTICE EDUC. 712-15 (1994).

<sup>76</sup>McDevitt, *supra* note 57, at 250.

<sup>77</sup>*Id.*

<sup>78</sup>*Id.* at 254.

seriously to the insights of others, especially those with different backgrounds and life experiences.”<sup>79</sup> One recent empirical study found that while most HIPs positively impact students, collaborative learning HIPs were among the most beneficial to them.<sup>80</sup>

On the mock trial team, students assume the roles of witnesses and attorneys as they develop a hypothetical criminal or civil case to present to a jury. Team members develop the entire case including preliminary matters, opening statements, direct and cross examination for witnesses, and closing arguments. The student attorneys must have a strong understanding of the Federal Rules of Evidence, as the fictional jurisdiction follows the federal rules. Witnesses must also know the rules as they develop their testimony to make sure their presentations will be admissible and effective. Students spend a considerable amount of time developing, testing, and critiquing each other’s presentations. A faculty coach guides the students through their preparation of the case by providing considerable feedback. The time spent analyzing the arguments and presentations of the opposing side is enormously beneficial to business students as a way to hone their critical thinking skills, even if the case itself involves a non-business related issue.

In addition to refining critical thinking skills, public speaking ability, and mastery of court rules, mock trial benefits students in several other ways. As a result of its time-intensive nature, mock trial clearly increases student engagement with peers, faculty, and course content. In order to optimize the benefits from the mock trial experience, a reflective observation where the student assimilates their observations into abstract conclusions is recommended for all participants.<sup>81</sup> This critical reflection exercise is intended to help deepen their learning experience, and given that mock trial generally spans both the fall and spring semesters, packs more of a punch than a one-time, in-class moot court project.

### C. CLIENT INTERVIEWS

The classroom offers an opportunity to provide experiential learning through reality based role-playing exercises. As in business, one of the foundational interpersonal relationships in the practice of law is the attorney/paralegal-client relationship. Before an attorney can argue the merits of a case, investigate the facts, or proceed to settlement discussions, there must be an open and honest line of communication with the client. The handling of a case starts first with the information gleaned from the client, and from that point, the attorney and client can determine an appropriate strategy to pursue. The level of trust between the two is of paramount importance, and to some extent is determined by their respective personalities. Each client is different, and the lawyer must be aware of the potential sensitivities of each to maximize the potential for success.

One scholar performed an extensive review of the texts used in Legal Environment of Business courses and found an undisputed need to promote analysis of legal and ethical issues and development of critical thinking skills in business school law courses.<sup>82</sup> Importantly, the study concluded that the textbooks largely failed to address the attorney-client relationship and a realistic

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<sup>79</sup>Kuh, *supra* note 3, at 20.

<sup>80</sup>Cindy Kilgo, et al, *The Link Between High-Impact Practices and Student Learning: Some Longitudinal Evidence*, 69 HIGHER EDUC.: THE INTERNATIONAL J. HIGHER EDUC. AND EDUC. PLANNING 509-25 (2015).

<sup>81</sup>Nees, *supra* note 55, at 176.

<sup>82</sup>Murray Levin, *The Attorney-Client Relationship as a Business Law-Legal Environment Topic*, 21 J. LEGAL STUD. EDUC. 241 (2004).

understanding of the legal profession.<sup>83</sup> This deficiency can be addressed through the use of a mock client interview.

Mock client interviews in the classroom can help encourage students to explore their own interviewing styles. Students have reported gaining a superior understanding of the significance of interviewing skills and recognizing that interviews involve both maximizing information gathering, as well as developing an empathy for the client.<sup>84</sup> Simulation exercises in client interviewing can lead to more effective interviewing skills for both pre-law undergraduate and law school students.<sup>85</sup>

Law schools frequently offer courses that allow students to engage in the experience of role-playing an attorney-client relationship. For example, Texas Tech Law School offers a “Legal Practice” course that centers on a mock client interview simulation.<sup>86</sup> George Mason University School of Law incorporates instruction on client interviewing in a Legal Clinic designed to assist active-duty military members obtain legal representation.<sup>87</sup> Further, Georgetown Law School incorporates a mock client interview during its first-year mandatory Legal Research & Writing course, thus illustrating the importance the law school places on this fundamental area within the practice of law.<sup>88</sup>

In response, many undergraduate legal studies programs now offer client interviewing opportunities.<sup>89</sup> The skills attained from such projects are just as important and useful for businesspersons dealing with their own clients or customers. Utilizing a mock client interview allows the business student to acquire and adapt the same skills that an attorney needs when communicating with a client. Interpersonal relationships share the same level of paramount importance in the business world as in the legal world, and thus incorporating such a project would help students with varied career plans. While it is apropos for a legal studies class to simulate an attorney-client relationship, a business instructor could adjust the scenario to include a potential customer or a new vendor. Pre-law students would still gain the necessary experience that such simulations provide.

An example of one kind of mock interview simulation can help to illustrate their value to both business and pre-law students. In a course on family law, the experience of conducting an initial interview with a client can be daunting and challenging. The initial client interviews are a valuable exercise that can put the students in the position of thinking on their feet and relying upon

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<sup>83</sup>*Id.* at 249 (noting that, “One can draw as a primary observation from this study that the attention devoted to the general attorney-client relationship topic is quite small.”)

<sup>84</sup>Carla MacDonald and Amy Biegel, *Using Role-Play to Teach Competencies for Acquiring Behaviors as a Social Worker*, NORTH AMERICAN ASSOCIATION OF CHRISTIANS IN SOCIAL WORK (October 2012), <http://www.nacsw.org/Publications/Proceedings2012/MacDonaldCUUsingRoleFINAL.pdf>.

<sup>85</sup>Donald Alderman, et al, *Assessing Clinical Skills in Legal Education: Simulation Exercises in Client Interviewing*, ETS RESEARCH REPORT SERIES (1980), <http://onlinelibrary.wiley.com/doi/10.1002/j.2333-8504.1980.tb01233.x/epdf>.

<sup>86</sup>Texas Tech School of Law, *Legal Practice Program*, <http://www.law.ttu.edu/acp/programs/legal/> (last visited May 4, 2016).

<sup>87</sup>George Mason University School of Law, *Clinics, Externships, and Legal Practicum*, <http://www.law.gmu.edu/academics/clinics/> (last visited May 4, 2016).

<sup>88</sup>Georgetown Law School, *Legal Research and Writing at Georgetown Law*, <http://www.law.georgetown.edu/academics/academic-programs/legal-writing-scholarship/upload/legalwriting2012.pdf> / (last visited May 4, 2106).

<sup>89</sup>*See generally* Morehead State University, *Legal Studies*, <http://www.moreheadstate.edu/study/legalstudies/> (last visited May 4, 2016); Berkeley College, *Legal Studies*, [http://berkeleycollege.edu/academics\\_bc/4350.htm/](http://berkeleycollege.edu/academics_bc/4350.htm/) (last visited May 4, 2016).

the substance and procedure that they have learned in class. The instructor of the course solicits faculty, theater students, or local attorneys and members of the community to come to class to serve as the hypothetical clients. The instructor provides the clients with a “client script” that sets out some basic demographic information and outlines a major legal issue or concern of that client.<sup>90</sup> Following the model set forth for the contract simulation, the assignment requires a flipped classroom where students are expected to be prepared for the interview before arriving in class. The interviews themselves occur during a regularly scheduled class, with the instructor available to resolve any confusion.

The student is required to greet and establish a rapport with the client. The next step requires the student to set the bounds of the attorney or paralegal relationship so that all sides understand the exact contours of the obligations and responsibilities each side assumes. The goal of the interview is for the student to identify the client’s main legal concerns and ask probing questions to elicit facts that the attorney will need in order to represent that client. For example, if the client’s foremost concern is alimony/spousal support, then the student is expected to ask the client questions about the employment history of both spouses and how the standard of living was maintained during the marriage. At the conclusion of each interview, the students and client engage in a debriefing session to identify strengths and potential alternatives to the interview. The debriefing sessions tend to demonstrate what the students learn from verbal and non-verbal cues, the importance of language, the value of empathy and how to apply the text of a statute to the problems of ordinary people.

Through the assignment, students must identify the real legal issues facing the client and the ethical issues confronting the attorney. They must evaluate the strengths and weaknesses of the case in light of the client’s wishes and expectations. This exercise requires upper-level cognitive skills, effective oral communication, strong critical thinking and reasoning. It also promotes collaboration and responsibility for learning that the students will need as they begin their careers. An added benefit is that in-class experiential learning provides realism that forces creative thinking and the management of uncertainty that exists in everyday life. This is an engaging classroom experience that promotes positive student feelings about learning and class participation.

#### IV. CONCLUSION

Undergraduate legal studies programs focus primarily on preparing students for the rigors of law school. With that mission in mind, legal studies curricula design learning opportunities to mimic those the student will experience at law school and in real life. Business programs, on the other hand, are not generally designed to put a laser focus on skills necessary for the practice of law. But, business schools can no longer afford to relegate or even ignore the needs of pre-law students, given the number of students who are increasingly choosing business as an undergraduate degree.

There is a better way. Business law courses, already built into most business curricula, provide an excellent outlet for inclusion of important skills without doing so at the expense of traditional business pedagogy. Business programs should borrow artifacts from legal studies programs and adjust them accordingly so as to benefit both the pre-law and non-law student.

The next frontier for law schools pedagogy involves a stronger emphasis on learning by doing. With that premise in mind, experiential learning projects such as the contract simulation or

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<sup>90</sup>See *infra* Appendix D for an example of a hypothetical client interview scenario.

client interview are efficient ways of utilizing limited classroom time to provide exposure to law school skills. Or, year-long mock trial cohorts can provide repeated exposure to legal simulations that can deliver longer-lasting effects. Importantly, employing these kinds of classroom projects do not detract from the overall mission of a business program – these skills are just as useful in an entrepreneurial setting as they are in law school.

## Appendix A

### Contract Drafting Principles

#### 1. Headings

Use clear headings throughout the document so that the reader can easily locate provisions within the document. You can use either a number or letter system to order your headings and subheadings. Make sure the document looks organized and readable.

#### 2. Page numbers

Be sure to number each page on the bottom. It is also useful to indicate the total number of pages in the document, and to include that in your numbering system (i.e., “Page 2 of 5.”).

#### 3. Identify the Parties and the nature of the agreement at the Beginning of the Document

An introductory paragraph at the beginning of the contract should be clearly worded to identify the document, the parties, and the date. Be sure to check for correct spelling, of course. Here’s an example:

“This Stock Purchase Agreement (the “Agreement”) is made and entered into as of June 1, 2004, by Billie Brown (the “Purchaser”) and Stacy Smith (the “Seller”).”

After identifying the parties, you can use their titles instead of their names throughout the rest of the document. Be consistent.

#### 4. Recitals

These clauses are used at the beginning of a contract to state the purpose of the agreement and the intentions of the parties. They appear before the provisions of the document in order to explain the reason for the contract and in order to provide background facts and statements. These are often quite helpful as well in order to state that valid consideration for the agreement exists, although it is not necessary to state that consideration exists as long as mutual promises exist. This is a traditional clause in contracts that most attorneys continue to use. Avoid using legalese in this section especially (“Witnesseth”) and write these in complete sentence form.

Here is an example of a recitals section of a contract:

“Company operates an industrial chemical business and wishes to hire Contractor as an independent contractor to sell chemicals on behalf of the Company.

Contractor is willing to perform sales services for the Company as an independent contractor.

In consideration of the mutual covenants set forth below, the parties hereby agree as follows:”

#### 5. Contract Provisions

Strive to put these into logical order in your contract. The most important provisions (related to duties of parties, payment/ compensation, time for performance) usually appear at the beginning of the document. The “housekeeping” provisions usually appear at the end of the document. Use headings and a consistent numbering or lettering system throughout your document.

6. **Damages Clause**

You should include provisions that spell out exactly what will happen in the event that one party fails to perform. This should be clearly stated, and will likely be one of the important parts of your negotiating. Also decide whether arbitration will be mandatory, and determine how attorney’s fees will be paid and include these provisions.

7. **Signature Section**

At the end of the document, you should provide signature lines for the parties. The signature lines may be preceded by a statement like: “The parties have executed this agreement on the effective date listed above and hereby agree to these provisions.”

8. **Venue Provision**

You should indicate that the laws of the State of Florida govern the agreement.

9. **Severability Clause**

You may want to include one of these clauses, which indicates that in the event that one contract provision fails, the other provisions will not be affected by that.

10. **Time is of the Essence**

Many contracts include language that states that time is of the essence. You might want to include this language in one of your provisions.

11. **Modification Clause**

The contract should indicate how the parties can modify the agreement. Typically, most contracts state that the agreement can be modified only in a writing signed by both parties.

12. **Avoid Legalese**

Many contracts which you will find online still include legalese. You must avoid legalese in your contracts by rewriting the language in plain English. Avoid such words as: “Hereinafter,” “Wherefore,” “Witnesseth,” “Aforementioned,” etc. Most of these words can either be eliminated or rewritten for clarity. You will lose points for including this language in your contract. Strive for clarity and readability.

13. **Proofread, proofread, proofread**

## Appendix B

### Contract Drafting Assignment AppServe Demand List

You represent AppServe, Incorporated, a computer software design firm specializing in the production, design, and implementation of mobile apps. A mobile app is a program running on iOS (Apple devices, such as the iPad or iPhone) or Android devices rather than traditional PC software. AppServe is in the business of taking ideas from third party customers and manufacturing, designing, and implementing the proposed application (or app) for the third party. AppServe receives a 15% royalty for their services – in other words, AppServe receives nothing upfront for the app, but instead receives 15 percent of all revenue generated by the sales of the app forever. If the app is unsuccessful, doesn't sell, is broken, or never hits the market, AppServe receives nothing from its customer. For iOS apps, there is an extensive "quality control" procedure that requires the app to meet certain minimum standards in order to be sold in Apple's App Store.

AppServe is looking to expand. Currently, it is based in Pensacola, Florida and has upwards of 20 total employees, 12 of which are actual App designers. The demand for its services has skyrocketed from potential customers nationwide. Nearly half of AppServe's customers are from out-of-state, with nearly 35 percent of their customer base either in California, Texas, or New York. The 12 designers simply cannot keep up with the demand, and so AppServe's CEO (John MoneyMaker) has decided to hire three new mobile app designers.

AppServe prides itself on its high quality work – therefore, it will only hire experienced, well regarded designers. No one straight out of college will be hired. AppServe maintains a 99 percent satisfaction rate and that is one big part of their tremendous success. AppServe uses traditional means to market and advertise, but by and large, most of their customers come from repeat business or word-of-mouth advertising by its clients. AppServe is currently valued at over 15 million dollars, with an annualized profit averaging \$1.5 million dollars per year. The proposed expansion could result in another \$1 million dollar increase in profit.

AppServe has patented a new process for quickly making apps. This process, called AppWeaver, is a patented, secret process whereby the same code can be used to make a wide variety of apps, thus greatly reducing the design time for making apps. Instead of having to start from scratch for every app, the foundation and underlying work for the code is the same, and cuts nearly 10-15 percent of the normal app-design time off.

AppServe posted an advertisement through traditional online channels, such as monster.com, and wanted a nationwide search. After an exhaustive interview and application process, three designers were selected for hire. One of these, represented by your opposing counsel, is Jennifer Williams. Ms. Williams' resume shows that she worked at Dell Computers in Austin, Texas for 12 years and came highly recommended by her previous employer. We do not know how much money she made at Dell, but we do know she was very excited about the possibility of moving to Pensacola with her family. She earned a Master's Degree in Computer Science at Duke University, where she had a 4.0 GPA. At Dell, she worked extensively in their app department making apps for Android devices. In sum, Mr. MoneyMaker was VERY impressed with Ms. Williams and desperately wants to hire her.

As part of the hiring process, all terms and conditions of employment are on the table, including salary and working hours. One thing that Mr. MoneyMaker demands that all of his employees sign is a non-compete and non-solicitation agreement – this is non-negotiable. Given

the secret nature of his patented AppWeaver and the time and resources he will pour into Ms. Williams' work, he finds it necessary to have a loyal employee base that he can trust.

As a result, AppServe wants as strict of a non-compete/non-solicitation agreement as it can force upon its employees. Additionally, they want to control and manage employee salaries. Here is a list of AppServe's demands and wants:

1. The average designer at AppServe makes \$75,000 per year. The salaries range anywhere from \$60,000 to \$95,000. Given Ms. Williams' resume and experience, AppServe knows that it might have to pay her more to entice her to come to work. Therefore, AppServe is willing to offer \$70,000 in an initial offer. It is willing to go as high as \$105,000, but no more. AppServe is concerned about giving a new employee more than any current employee and what that might do for morale, so AppServe would strongly prefer that Ms. Williams' salary be no more than \$90,000. This is a MEDIUM priority.
2. AppServe believes in a collegial and networked work environment. That said, it wants all of its employees to work a standard 8-5 work day Monday-Friday, with occasional weekend work shifts when deadlines approach. On the other hand, this is not a high priority – there are currently 2 designers that have “remote offices” where the designers work from home 2 days per week. AppServe would be willing to allow Ms. Williams to work away from home up to 3 days per week, but the ideal situation would be to have her in the office 5 days per week. This is a LOW priority.
3. As for the non-compete agreement – AppServe does not want its former customers working for competitors after they leave the company. They are concerned about the secrecy of AppWeaver as well as the possibility that designers, who closely work with the customers, might “steal” those customers away based on their previous working relationships. Therefore, AppServe wants a 2 year non-compete/non-solicitation agreement. The lowest time the company would agree to is 1 year. The length of the agreement is a HIGH priority.
4. AppServe wants the non-compete agreement to cover all areas where it currently has customers, to prevent former employees from using their knowledge in the places where these customers live. Therefore, AppServe wants the non-compete to cover all of Northwest Florida and South Alabama. This is a HIGH priority. Additionally, AppServe wants the agreement to cover all of Florida, California, Texas, and New York, since they have a huge customer base in those states. This is a MEDIUM priority. Finally, AppServe's ideal preference would be to have the non-compete agreement cover all 50 states, just to be sure they have full protection. This is a LOW priority.
5. AppServe certainly wants to prevent Ms. Williams from working for a competing software company. The theory behind this is that AppWeaver is so important to its business and does not want it used by competitors. Secondly, AppServe will be extensively training Ms. Williams on successful and proven app design strategies that have been shown to work in AppServe's business. AppServe does not want these strategies to be used by their competitors. Those that design or do any kind of work with apps are the most important to be covered by the non-compete clause. Although Ms. Williams will only be designing, and not testing or implementing apps, AppServe wants the agreement to cover ALL aspects of mobile app development. This is a HIGH priority.
6. AppServe is considering expanding into other areas of computer technology. Specifically, 18 months from now, AppServe will launch a new PC program called OfficeWeaver that will be a new word processing program that will be downloadable onto PCs. Later, a tablet version of the program will also be released. Even if Ms. Williams does not work on this

project, AppServe wants to prohibit her from working for a competing software design firm that specializes in all software design. This is a HIGH priority.

7. AppServe wants a non-disclosure agreement that prevents Ms. Williams from ever releasing any details about AppServe's products, processes, programs, or customers. This is a HIGH priority.
8. AppServe would prefer if Ms. Williams did not start up and own a competing business against them. Interestingly, though, AppServe isn't concerned about former employees directly competing against them, despite the fact that they would have important information about how AppServe works. They highly doubt that anyone could effectively compete with them and gain the reputation they have. Plus, AppServe thinks they could easily "squash" such new competition by convincing customers that she is an inferior worker with an inferior product. This is a LOW priority.
9. Finally, in order to justify the non-compete agreement, AppServe wants to require extensive training on apps in general from external conferences and then undergo an extensive in-house training program on its products and design. Specifically, AppServe wants Ms. Williams to undergo 4 months of external and internal training before starting any real app design for the company. AppServe will call this a "probationary" period. The company would be willing to only accept 1 month of training, but 4 months is the ideal amount. This is a MEDIUM priority, except that having at least 1 month is a HIGH priority.
10. AppServe wants Ms. Williams to begin work as soon as possible, but is willing to work with her on the timetable for moving to Pensacola. Assume today is April 1, 2016. Ideally, she would begin work immediately, but the company is willing to wait to have her start for up to three months from now. However, she must start work no later than July 1, 2016. This is a LOW priority.

## Appendix C

### **Contract Drafting Assignment** **Jennifer Williams Demand List**

You represent Jennifer Williams, a prospective new employee at AppServe, Incorporated. AppServe is a computer software design firm specializing in the production, design, and implementation of mobile apps. A mobile app is a program running on iOS (Apple devices, such as the iPad or iPhone) or Android devices rather than traditional PC software. AppServe is in the business of taking ideas from third party customers and manufacturing, designing, and implementing the proposed application (or app) for the third party. AppServe receives a 15% royalty for their services – in other words, AppServe receives nothing upfront for the app, but instead receives 15 percent of all revenue generated by the sales of the app forever. If the app is unsuccessful, doesn't sell, is broken, or never hits the market, AppServe receives nothing from its customer. For iOS apps, there is an extensive "quality control" procedure that requires the app to meet certain minimum standards in order to be sold in Apple's App Store. Currently, AppServe is based in Pensacola, Florida and has upwards of 20 total employees, 12 of which are actual App designers.

Jennifer was working at Dell Computers in Austin, Texas at the time she applied to work for AppServe. Her annual salary at Dell was \$68,000. Jennifer graduated from Duke University with a degree in computer science, where she had a 4.0 GPA. At Dell, she worked extensively in their app department making apps for Android devices for the last 5 years. Prior to that, Jennifer worked in PC software design where she made products that eventually were used by Microsoft and Cisco Systems. Jennifer's boss, Pete Cameron, highly valued Jennifer's work and believed her to be the best designer in the department. Jennifer, however, grew more unhappy with her time at Dell. Jennifer wanted to move to the iOS Department and design apps for Apple products, simply because that was where the growth in the industry was occurring. Jennifer wanted to get out of working on Android devices, but the iOS Department at Dell had no openings. She was promised a chance to transfer, on several occasions, when a job opening came up, but there was always some reason or excuse someone else was promoted or hired. Pete understood Jennifer's decision to relocate elsewhere and fully supported her decision.

Jennifer has a husband and two children – ages 8 and 6. Her family life is very important to her and she regrets having to spend so much time apart from them the last five years. She is determined to make her children more of a priority in balancing her home life with her work life.

As a result, Jennifer began looking for potential jobs beginning in December of 2014. She primarily checked monster.com for openings. On January 5, 2016, AppServe posted an advertisement on monster.com for an iOS/Android designer. Jennifer had heard of AppServe – they were a highly respected, up-and-coming company that was leading the industry in terms of designing apps for customers. She was very excited at the job prospect and applied for the job. She stressed her Android experience in her resume, and noted her willingness and even eagerness to begin work on iOS products as well. After an exhaustive interview process with the CEO of AppServe – John Moneymaker – she was selected for hire. The interviews were held in-person in Pensacola, and Jennifer believed John liked her from the start. He seemed very impressed with her resume and they seemed to immediately develop a professional chemistry. Mr. Moneymaker discussed the job requirements, which would be to design apps for third-party customers on both Android and iOS. Mr. Moneymaker also told her that AppServe uses a top secret programming code called AppWeaver that uses the same code that can be used to make a wide variety of apps,

thus greatly reducing the design time for making apps. Instead of having to start from scratch for every app, the foundation and underlying work for the code is the same, and cuts nearly 10-15 percent of the normal app-design time off. Mr. Moneymaker asked Jennifer if she thought learning a new code would be difficult for her, and she responded that she was very familiar with learning new codes, especially one as fascinating and groundbreaking as AppWeaver. Mr. Moneymaker is desperate to ensure that AppWeaver is only used by AppServe and never by any of his competitors.

Two days after the interview, on March 20, 2016, Mr. Moneymaker personally called Jennifer to offer her the job, subject to certain terms and conditions being negotiated. Jennifer immediately accepted right there on the phone.

Jennifer is very excited about the job. She feels that she will make more money (since she'll be doing a variety of tasks and a profitable company, and she deserves more money based on her credentials). She also thinks the move will be better for her family, in a location near the beach for the kids. She also hopes that the workload will not be as strenuous as it was at Dell. She really wants this job to be her "dream job."

When Mr. Moneymaker offered Jennifer the job, he stressed to her that, as part of the hiring process, all terms and conditions of employment are on the table, including salary and working hours. One thing that Mr. Moneymaker demands that all of his employees sign is a non-compete and non-solicitation agreement – this is non-negotiable. Given the secret nature of his patented AppWeaver and the time and resources he will pour into Ms. Williams' work, he finds it necessary to have a loyal employee base that he can trust.

Mr. Moneymaker tells Jennifer to hire a lawyer to hammer out the details of the employment contract. He finds it easier when others deal with the negotiating so that there will be no personal hurt feelings from the beginning. Mr. Moneymaker tells Jennifer that the lawyers will begin hammering out the details on April 1, 2016. Assume today is April 1, 2016.

As a result, Jennifer knows that she will be required to sign a non-compete agreement. She wants it to be as least restrictive as possible. She's not 100 percent sure that AppServe will work out for her and she wants to have some flexibility in future employment in case, for whatever reason, the AppServe position is not right for her. Importantly, she is very concerned about being to get some sort of job in her field if she leaves AppServe.

Here is a list of Jennifer's demands and wants:

1. Jennifer wants a raise from her prior job. She knows that the average app designer in the nation makes around \$82,000. She believes she is worth at least that much and that is the absolute minimum that she will accept as salary. However, Jennifer also feels that she is more qualified than the average designer and strongly believes she should make at least \$95,000. She truly believes, even if it is unlikely, that she is worth \$115,000 per year. This is a MEDIUM priority.
2. Jennifer really wants to spend more time with her kids, and is interested in the possibility of "telecommuting" to work. Since most of the design work can be done from home, she sees no reason why she couldn't work from home some days as a way to spend more time with the children and out of the office. She knows that working full-time away from AppServe's office isn't practical, though. She would prefer to be able to work Monday, Wednesday, and Friday from home and go to the office on Tuesday and Thursday. But, she'd be willing to accept even just one day at home, since that would be an improvement on her former work life. This is a HIGH priority.
3. Jennifer has a family life and not having gainful employment for too long would quite simply lead to financial problems. She understands that a non-compete agreement is

important for AppServe and in fact she had to sign one at Dell (the Dell non-compete didn't cover Florida). She'd prefer a shorter time limit, maybe closer to 8-9 months. She thinks 18 months is the most fair, but understands that it is fairly standard practice to have a 2 year non-compete agreement. This is a MEDIUM priority.

4. Jennifer is willing to sign a non-compete agreement to cover Escambia and Santa Rosa Counties in Florida, plus all counties in and around Mobile, Alabama – she understands AppServe's demands in those areas and thinks that's fair. Jennifer does not have roots here and if fired or if she quits, she wouldn't continue to live in Pensacola anyway. However, she does not want any nationwide non-compete agreement because a nationwide non-compete agreement would freeze her out of the job market totally. She especially wants to exclude Texas from the agreement, since she is from there and has contacts there who would hire her back quickly. Texas is a HIGH priority. As for the other areas other than northwest Florida, South Alabama, and Texas, it is a MEDIUM priority to allow her to work in any of those areas. She simply does not want to limit any future employment opportunities.
5. Jennifer knows that the noncompete agreement will cover competing businesses; that is, those businesses that do the same kind of work as she would be doing. Although she will only be working on the design phase of apps, AppServe as a whole also implements, tests, and coordinates app development. She would prefer that the non-compete agreement only cover working for competing businesses that also DESIGN mobile apps, since that would be her sole job at AppServe. She would still like the option to work as a tester for a mobile app company, especially since she would not be doing the testing at AppServe. This is a HIGH priority.
6. Since AppServe deals in mobile apps, she understands that will be the focus of the non-compete and is willing to accept that aspect of the deal. Although she would prefer to keep the scope of the agreement as limited as possible, she has no desire to ever work in any other field other than mobile apps. So, if the agreement covers other aspects of computing, such as PC software design for example, she is fine with it. This is a LOW priority
7. Jennifer would like some money for moving expenses. It will cost roughly \$1,500 to move her from Austin to Pensacola as cheaply as possible (this would require her to actual load and unload her stuff). The average in the industry for moving expenses is anywhere from \$1,000-\$2,000. She would accept \$1,000, but would really prefer upwards of \$2,000-\$2,500. This is a MEDIUM priority.
8. Jennifer has always had the idea of opening up her own business one day. She believes that if she ever left AppServe, one thing she might consider is opening up her own business instead of working for yet another competing business. So, Jennifer would love to keep the non-compete agreement limited to restricting her from working at another business and to not restrict her from actually opening up her own business. This is a MEDIUM priority.
9. Mr. Moneymaker informed Jennifer in the interview that there will be an initial probationary training period where Jennifer will receive extensive training on apps in general from external conferences and then undergo an extensive in-house training program on its products and design. Plus, Jennifer will need to learn the ins and outs of AppWeaver before actually starting. AppServe will call this a "probationary" period. She wants to get to work on real projects as soon as possible. She thinks she can pick up AppWeaver knowledge quickly, and she has enough experience to hit the ground running. Making mobile apps for iOS really excites her from a personal fulfillment perspective, so

she certainly doesn't want to wait too long to get going. She wants to forego all training – that is a MEDIUM priority. But, she understands that AppServe might insist on some training. Having no more than 2 months of training is a HIGH priority.

10. Finally, Jennifer knows AppServe wants her to begin work as soon as possible after the agreement is signed on April 1, 2016. However, she would prefer to start working in June so that her children can finish the school year in Austin and not be taken out of a class mid-year. She's more than happy to start June 1, 2016, since the school year in Austin ends May 28, 2016. This is a MEDIUM priority.

## Appendix D

### Instructions for Client Interviews for Student Interviewing Teams

You work as a Paralegal in a medium sized law firm with a variety of specializations, including family law. You are employed as a student intern for Jane Smith, Esq., whose practice is 95% family law, and you assist in annulment, divorce, separate maintenance, custody, child support, paternity, adoption, and related family law matters. A prospective client is coming to the office for an initial interview. The client will meet with you first for an initial interview to determine the client's legal problem and Ms. Smith will join the interview at the end.

Your assignment is to gain as much information about the client's legal problem as possible by asking the client to provide you with facts necessary to represent them. The client has already completed the intake form which contains all the basic demographic data. This is important information that may be relevant to your interview but do not ask questions that are already answered on this sheet. Keep notes on your interview. Do not spend excessive time on completing the mundane details of the client's life at the expense of getting the details of the client's primary legal problem. You should be focusing on what questions to ask in order to help the attorney solve the client's legal problem. Be thorough but sensitive in your questioning as well as collecting the factual information that is not on the intake sheet but that is needed to help solve the client's legal problem. Do not be afraid to ask hard questions, but ask them with sensitivity and awareness of feelings that may be involved.

Beware of committing UPL! Therefore, you are not authorized to give legal advice or discuss legal fees with the client, even though you know what hourly fees the office charges for you and the attorney, and that the client will be asked to sign a fee agreement.

After the interview, the interviewing team, the client and the class will discuss:

- what you experienced as an interviewer/client/observer
- what you think was done well and what you could have been done better
- information that was not obtained from the client, but which needs to be obtained from this client in order to solve the legal problem
- what you learned about yourself as an interviewer, client, observer

#### CLIENT INTAKE INFORMATION

**CLIENT'S NAME:** Courtney Turner Stafford

Address: 1345 E. Jordan Street, Pensacola, FL 32503

Employment: Cosmetologist, Betty's Curl Up N' Dye  
9140 N. Ninth Avenue, Pensacola, FL. 32503

**SPOUSE'S NAME:** Frank Benjamin Stafford, Sr.

Address: 4261 Johnson Avenue, Apt. 24, Pensacola, FL 32504

Employment: Licensed Plumber, Roger's Plumbing  
3214 Alcaniz Street, Pensacola, FL 32502

Attorney for Spouse: Gayle Ryba

**DATE/PLACE OF MARRIAGE:** November 15, 2000/Pensacola, Florida

**DATE OF SEPARATION:** January 3, 2016

**HUSBAND AND/OR WIFE MEMBER OF MILITARY?** No

**IS WIFE CURRENTLY PREGNANT?** No

**GROUND FOR DISSOLUTION OF MARRIAGE?** Irretrievably broken

#### ASSETS AND LIABILITIES

There is no written agreement between the parties regarding division of marital assets or liabilities. The trial court will have to make this determination at final hearing. Title to the marital home (1345 E. Jordan Street) is held as Tenants by the Entireties

2008 Honda Accord and 2007 Ford F-150

Savings Account

Master Card and Visa credit cards

All other Personal Property (H+W divided when they separated)

**SPOUSAL SUPPORT INFORMATION**

Spousal Support:

Our client does want spousal support but, leave the amount, frequency, type and explanation blank when you fill out the forms until your supervising attorney can discuss this in detail with the client.

Life Insurance:

H should continue to carry life insurance on his life to secure the spousal support if he dies before spousal support terminates.

H+W met in high school and married soon after.

Wife: Earned her high school degree and has taken some college classes.. Wife has always relied primarily upon H for financial support. She was a stay at home Mom until the kids started first grade but has worked continuously since then at the same job. However, she needs continued financial help from H after the dissolution.

Husband: He has always been the primary bread-winner (superior ability to pay support). He has worked continuously during the marriage at the same employer.

**DEPENDENT/MINOR CHILDREN BORN OF THIS MARRIAGE:**

NAME	PLACE OF BIRTH	BIRTH DATE	SEX
Kayleigh Stafford	Pensacola, FL	April 1, 2004	F
Frank Stafford, Jr.	Pensacola, FL	Aug. 4, 2000	M

There are no other children of either party.

There are no prior or current proceedings involving these children.

**RESIDENCE ADDRESSES OF CHILDREN:**

1345 E. Jordan Street, Pensacola, FL 32503 – Nov. 15, 2000 to Jan. 3, 2016 with both parents

1345 E. Jordan Street, Pensacola, FL 32503 - Jan. 3, 2016 (date of separation) to date with just Mom.

2101 E. Lakeview Street, Pensacola, FL 32503 – Aug. 4, to Nov. 14, 2000 (with maternal grandparents, Margie and Norman Turner and both parents)

**PARENTING INFORMATION**

Children are currently residing with W at marital home.

The parties have agreed and signed a Parenting Plan.

H has been exercising regular visitation without any problems.

**CHILD SUPPORT INFORMATION**

See Financial Affidavits that were prepared and filed by each party.

Child Support:

The parties have been unable to agree on a child support amount so the court will need to determine the amount.

Our client would like the child support to be retroactive to the date of separation.

No deviation from the guidelines is being requested.

Child’s Health Insurance/Expenses:

The father should continue to pay for health insurance for the children through his employer.

H + W have agreed to split non-covered medical/dental expenses based on Child Support Guideline Worksheet percentage.

Life Insurance:

The father should continue to carry life insurance on his life to secure the child support if he dies before child support terminates.

**NAME CHANGE?**

W does not want to change her name at this time

**ATTORNEY FEES AND COURT COSTS**

The husband should be required to pay the wife's attorney's fees and court costs as "other relief."



## LOOKING BEYOND THE PALE: EVIDENCE THAT INVESTORS LOOK BEYOND CONCURRENT ANNUALIZED RETURNS IN ASSIGNING CORPORATE REPUTATIONS

Winner of the 2016 MBAA International  
McGraw-Hill Education Distinguished Paper Award in Finance

THOMAS M. KRUEGER\*

MARK A. WROLSTAD\*\*

### ABSTRACT

*This analysis evaluates the impact of public perceptions of corporation's reputations on shareholder returns. We use Reputation Quotients (RQs) produced by Harris Interactive since 1999 to objectively quantify corporate reputations and we look at both price-based returns and total returns (i.e., including dividends). From the list of 60 firms published each year, the Reputation Quotient (RQ) scores are used to gauge corporate reputations and create portfolios of the ten corporations with the highest RQs (TOP10) and another portfolio consisting of the ten covered companies with the lowest RQs (BOT10) for each year. This study addresses a potentially biasing factor found in past RQ studies which assumed that the impact of a firm's reputation lasts exactly one calendar year, regardless of the actual number of intervening days between the yearly announcements and subsequent portfolio reallocations. To enhance the validity of potential findings, this research studies annualized returns. We find that the BOT10 portfolios generate higher returns and have much more risk in terms of both standard deviation and beta when compared to the TOP10 portfolio. Consequently, risk-adjusted returns are found to be higher for the TOP10 portfolio. The difference between the two portfolios is not statistically significant, suggesting that investors may be looking beyond the pale of current stock market performance when classifying a firm's reputation. In only one instance were we able to detect investors appear to be considering current stock market conditions.*

### INTRODUCTION

The accurate measurement of corporate reputations is critical from both an internal and external perspective. From an internal perspective, accurate current information is necessary to effectively manage a firm's reputation. A firm needs to know

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whether it should take steps to reinforce its positive current reputation or revise its practices as the business attempts to improve its negative reputation. Without a reliable measure of reputation, a firm does not know the extent to which recent events and additional information available to the public have helped or hindered its reputation. From the outside of the firm, investors benefit from reliable reputation information when evaluating a company as a potential investment opportunity. Our research is based on the premise that the Reputation Quotient (RQ) developed by the Reputation Institute in conjunction with Harris Interactive is a credible measure of a firm's reputation. Based on this assumption, we compared the stock market performance of the ten firms with the highest RQs (TOP10) to the ten firms with the lowest RQs (BOT10) taken from a list of the 60 company's RQs published each year.

This is not the first study comparing the performance of firms with high RQs to those with low RQs. Prior research (e.g., Krueger and Wrolstad (2007), Krueger, Wrolstad, and Van Dalsem (2009) and Krueger, Wrolstad, and Van Dalsem (2010)) assumes an investment horizon of one year regardless of the duration of the intervening period between annual publication of RQ values. As shown in Table 2, the time between public announcements has ranged from 256 to 507 days. The artificial assumption that the RQ's impact lasts for exactly 365 days has the potential to confound the results. When the interval between RQ announcements is short, there has been an understatement of the impact of a given RQ announcement. At the opposite extreme, when the interval between RQ announcements is long, the impact of a given RQ announcement is overstated. For instance, if either the TOP10 or BOT10 portfolio earned a 0.25 percent market monthly excess return, an eight-month interval would find a 2.0 percent rate of excess performance, while a 17-month interval would be assigned a 4.25 percent rate of excess performance if you ignore the effects of compounding. The variation in excess performance is likely to diminish the statistical significance of the effect being considered. Although one could argue that an investor using the RQ methodology could shift to cash twelve months after an RQ announcement, it is more probable that they would leave their funds in an RQ-based portfolio awaiting the next RQ press release. For this research, we recast the holding period returns into annualized return streams and we have completed a detailed investigation of return, risk, and risk-adjusted return performance. An additional change from previous work done by Krueger, et. al. is the seventy-five percent increase in observations available which is achieved by the passage of the years since the previous research was completed.

The following literature review reveals the results observed in prior studies of corporate reputation, returns tied to corporate reputation, and the RQ measure itself. Findings of our research are then presented and followed with some suggestions to further investigate the relevance of the RQ measurement of corporate reputation.

## LITERATURE REVIEW

### Measuring Corporate Reputation

Unfortunately, there is no single, agreed upon metric by which corporate reputation is measured. Six different definitions of corporate reputation are examined by Lloyd and Mortimer (2006), noting that the importance of key relevant firm characteristics (i.e., ethics, product, performance) in setting reputation opinions varies by stakeholder group. The proliferation of reputation measures encourages chaos and confusion regarding the value of a company's reputational assets. Wartick (2002) finds that there is a deficiency in terms of both the definition of corporate reputation and data used to measure reputation once the definition is set. He claims that this deficiency arises because the theoretical development of the reputation construct is insufficient. Ironically, ten years earlier Wartick (1992, p. 34) had defined corporate reputation as "the aggregation of a single stakeholder's perceptions regarding how well organizational responses are meeting the demands and expectations of many stakeholders." Putting the reputation paradigm in a more comparative perspective, after reviewing several definitions, Gotsi and Wilson (2001), define reputation as an evaluation based on any "communication and symbolism that provides information about a firm's actions and/or a comparison with the actions of leading rivals." Bitektine (2011) describes how evaluators make their social judgments under conditions of bounded rationality and how cognitive and social factors influence this process. His proposed process model of social judgment formation highlights the complex and nondeterministic nature of this process. In a recent review of the organizational reputation literature, Lange, Lee, and Di (2011) contrast 43 different articles on the subject found in *Corporate Reputation Review* and *Business & Society* alone.

Much of the concern regarding a firm's reputation arises from its documented relationship with financial performance. In fact, Fombrun (the primary force behind RQ development in 1998) and Shanley (1990, p. 233) assert that corporate reputation provides a signal regarding product quality that may enable highly-regarded firms "to charge premium prices, attract better applicants, and enhance their access to markets and attract investors." Hon (1998) documents corporate reputation's impact on the financial value of public relations efforts and the media placement chosen.

After defining corporate reputation, one still has to accurately measure it. According to Kioussis, Popescu, and Mitrook (2007), one of the most widely used reputation barometers is *FORTUNE* magazine's annual reputation index. However, Brown and Perry (1994) and Fryxell and Wang (1994) have criticized *FORTUNE*

magazine's heavy reliance on CEO perceptions and analyst opinions. In this research we follow the lead of Kiousis, Popescu, and Mitrook (2007), who cite the Reputation Quotient as a valid measure of corporate reputation.

### **The Reputation Quotient: Metric Creation**

In 1998, Charles Fombrun and Christopher Foss of the Reputation Institute firm invited Harris Interactive (a market research firm) to collaborate in the development of an appropriate measure of firm reputation. Creation of the RQ metric was consistent with the Reputation Institute's focus of providing confidential assistance to companies seeking to understand and enhance their reputations. Their objective was to come up with a standardized, quantitative reputation measure which would be appropriate across industries.

Their process begins by asking a large number of people to name businesses that they are familiar with and about which they have an opinion as to whether they like and respect the companies or not. Those surveyed are then asked why they like or dislike a given company. The responses revealed that feelings about company reputations were justified by at least one of twenty attributes. Fombrun and Foss merged these attributes into six dimensions, which are:

- A. Emotional appeal – company admiration; an emotional appeal based on trust and respect
- B. Products & Services – rational assessment of quality, innovation, value, of product reliability
- C. Financial performance – profitability, prospects, and risk
- D. Vision & Leadership – clear vision and strong leadership
- E. Workplace environment – desirability as an employer
- F. Social responsibility – good community citizen concerned about environment

The reliability of the RQs is enhanced by interviewing large numbers of residents in the United States and Australia. For example, Fombrun and Foss (2001) report contacting over 100,000 people during the first two years of the surveys. Those surveyed consistently listed over 200 companies with either outstandingly good or outstandingly poor reputations. This current analysis is based upon the 60 companies' RQs that the Reputation Institute publically releases each year. The annual list of 60 firms contains well-known firms that gained their usually deserved reputations from events and/or actions taken by the companies that are viewed by the public as being either positive or negative.

Although the generalized characteristics used in measuring corporate reputation are readily available, little information has been provided about how the constructs are operationalized or the relative weightings of each dimension. Some insight into how the RQs are probably calculated is found in the "word-of-mouth communications research" done by Allsop, Bassett, and Hoskins (2007). Their research analyzes the series of questions about media usage and social network activity that are used by Harris Interactive to shed some light on how corporate perceptions are formed. They created a series of Bayesian belief networks for four companies, one each from the automobile, retail, IT, and the electronics industries. Their analysis found that emotional appeal and perceptions about a company's products and services had a high impact upon corporate reputations. What these two factors had in common was that they both are largely driven by word-of-mouth. The authors also observed the presence of a multiplier-like effect, wherein positive communication about one of the six dimensions may influence an outsider's perception of other dimensions of a firm's reputation as well. Our research tests the importance of the current financial performance dimension.

### **Prior RQ Reputation Metric Research Findings**

Fombrun and Foss (2001) show that a weakened reputation negatively impacts share price and diminishes shareholder interest. They claim that a hidden cost diminishes the return of firms with poor reputations. Fombrun and Foss report that a 60% difference in reputation scores resulted in a 7% difference in market value. In dollar terms, an additional \$53 million in market value is attributed to an increase in reputation from 6.0 to 7.0 (on a 10-point scale). An example of how reputation, public perception and market capitalization moved in tandem for International Business Machines can be found in Rindova and Fombrun (1999). This research was expanded upon by Pfarrer, Pollack, and Rindolva (2010), who observe highly regarded firms experiencing higher stock market "price rewards" for positive surprises and a lesser stock market reduction following negative surprises. Researchers at the University of Kansas found that the benefit of rising from 6 to 7 on a ten-point scale was worth \$500 million (Black, Carnes, and Richardson, 1999). The Reputation Institute studied the 35 companies whose RQ had been measured in both 1999 and 2000. The strength of this research, reported by Fombrun and Foss (2001), is that it divided the sample into firms with advancing RQ measures and those with declining RQ measures. The authors found that a one 1-point increase on a ten point scale increased firm value by \$147 million, while those companies experiencing a 1-point drop experienced a decline of \$5 billion! It appears that there may be a wide range of opinions regarding the economic value of corporate reputations.

Based upon their efforts to create a robust measure of reputation, Fombrun and Foss (2001) assert that their RQ is a valid measure of corporate reputation that can be

used across countries and industries. They performed an out-of-sample analysis to verify that the calculated RQs are valid using exogenously-generated reputation data. The robustness of their findings has led the researchers to assert that RQs are “rapidly developing into a standardized instrument for assessing reputations around the world.” (Fombrun and Foxx, 2001, page 1).

One of the first thorough analyzes of the RQ measure was based upon only the first six RQ announcements (Krueger and Wrolstad, 2007). Share price performance on the day of the announcement and the year after the announcement were identified. No effort was made to adjust for situations where there was an overlap of year-long holding periods. Krueger and Wrolstad found the ten firms with the worst reputations had a higher average rate of return during the ensuing year, but more risk. Risk-adjusted returns were higher for the ten firms with the best reputations, with the authors asserting that the small sample size diminishes the opportunity to observe a significant difference. Our study is a great improvement on this initial study because it uses more than twice as many data points, studies the period leading up to the release of reputation rankings, and is based on annualized returns. As a consequence, there is no overlap in holding periods and we include the entire time period up to the next RQ announcement. Stated another way, there is no double-counting or exclusion of any time periods.

The impact of stock market performance on firm reputation was the focus of a study, Krueger, Wrolstad, and Van Dalsem (2010). Their study of the impact of stock market performance on corporate reputation was based on eight observations and consisted of the return contemporaneous with changes in corporate reputation. Although improving on prior research by using eight RQ changes, they again assumed the impact of a firm’s reputation would end one year after the RQ announcement date. Firms with diminishing reputations tended to have higher stock returns and greater risk. As a consequence, risk-adjusted returns were similar to that of firms with improved reputations. In a companion study, Krueger, Wrolstad, and Van Dalsem (2009) found that higher returns for firms with diminished reputations persist for the year after RQs are released. In both cases, the unexpected result of better performance by low reputation firms was attributed to what Porritt (2005) has referred to as a “bottom line backlash effect,” or the likelihood that the poor reputation of a successful firm could arise from the criticism of firms earning profits at the expense of their customers and society in general. Our investigation uses seventy-five percent more observations and does not limit itself to the first year following the release of RQ values.

Even if reputation can be described and measured, one still has to identify what constitutes a “good” versus a “bad” reputation. Harris Interactive has identified a hurdle above which it considers firms to have an “excellent” reputation. In a recent study,

Gonzalez and Krueger (2015) used this information to compare the stock price performance of firms with excellent reputations relative to the Standard & Poor's 500. In years with at least two firms in the "excellent" reputation category, equal investment in the "excellent reputation" firms provided a significantly higher rate of return relative to the Standard & Poor's 500 Index.

## RESEARCH METHOD

### Sample

Harris Interactive began reporting reputation quotients in 1999. On February 3, 2014 Harris Interactive was acquired by Nielson Holdings N.V. to reportedly bolster the proprietary information Nielson supplies to manufacturers and retailers (Feltner, 2014). As of this writing in January 2016, no post-acquisition RQs have been publically released suggesting that Nielson does not plan on continuing the process described above and making RQ information publically available. This analysis is based upon all fourteen reputation quotient (RQ) reports made prior to the acquisition of Harris Interactive by Nielson Holdings.

In this research two portfolios are created, one consists of the covered firms with the ten highest reputations (TOP10) and the other consists of the ten lowest reputations (BOT10), as measured by Harris Interactive. Equal investment in all 10 companies in each portfolio is assumed. A larger sample would dilute the potential impact of the RQ measure while a smaller sample would increase the likelihood that unique events at individual companies would confound results. Given that RQs are reported for 60 companies, our investigation captures the performance of one-third of the firms, with an equal initial number selected at both extremes. Portfolio membership is updated on the day each RQ study is released by Harris Interactive. This analysis could be theoretically based on 280 firms, consisting of 140 firms (i.e., ten high RQ firms taken from each of fourteen surveys) with outstanding reputations and 140 with poor reputations. However, Harris Interactive periodically includes a company in its survey which is has never been publicly-traded (i.e., S.C. Johnson), has been acquired (i.e., Bridgestone), or either goes bankrupt or is acquired before the next RQ survey is released (i.e., Merrill Lynch and Chrysler, respectively). A complete listing of all companies with extreme RQ ratings that are not in the sample for these reasons is presented in Table 1. Information on only one company with a high RQ rating (i.e., S.C. Johnson) is not available, resulting in this segment of the investigation being based on a total of 139 observations of performance by firms with widely accepted reputations.

As depicted by Table 1, most of the missing data exists within the low RQ segment of the empirical sample. After adjusting for the number of instances without complete information among the set of firms with low RQ measures, the impact of low reputations is being estimated using 122 observations, or 87 percent of the relevant population. Although additional firms with low RQ measures could be added, their inclusion would add firms with less extreme reputations, which is likely to confound the results. To the extent that firms listed in Table 1 earn lower returns than other firms in the BOT10 portfolio when they file for bankruptcy, the impact of the missing values is a bias in favor of finding less of a difference between the return performance of the TOP10 and BOT10 portfolios. Although the asymmetric distribution of missing values leads to the warning that these results should be viewed with caution, excluding firms that provide total losses to investors results in a more conservative analysis of the importance of corporate reputations. It is not possible to include the bankrupt firms by assigning a complete loss to such investments, because trading has frequently halted prior to inclusion in the RQ announcement.

This study addresses the explanatory nature of firm reputations. The explanatory hypothesis postulates a causal relationship running from share price performance to company reputations. In order to test for the occurrence of this phenomenon, we analyze share price performance during the period leading up to release of the RQ survey results. This study expands upon the research done in Krueger, Wrolstad, and Van Dalsem (2010) in two ways, by considering additional RQ announcements and by being based on annualized returns.

### **Justification for Annualizing Returns**

Unlike quarterly or year-end financial reports, an exogenously-fixed time schedule does not exist for the release of information on firm reputations. Reputation quotients are also not as highly anticipated or widely-reported as Harris Interactive's political surveys. Consequently, RQs are not reported on a fixed periodic schedule. As shown in the first row of Table 2 the average time between the releases of reputation quotients is slightly over a year, coming in at 1.04 years or 379 days. If you were to take the total number days from the first to the 2014 RQ announcement and divide by 14 you would end up with a value of 1.03. The extra 0.01 is tied to leap years, which occurred in 2000, 2004, 2008, and 2012. The extent to which this number exceeds 365 is the difference between the calendar date when the first reputation quotient was released in 1999, and the last pre-acquisition RQ announcement in 2013. Of course this is an extensive process that frequently begins in the prior year with identification of the sixty most prominent firms. For example, the 2013 announcement is based upon information for which the survey process began in 2012.

The median time between observations is an almost identical 1.02 years or 371 days. A similar mean and median suggests that the distribution of announcement periods exhibits little if any skewness. However, one should not take this similarity as a guarantee that there has been little variation in the length of time between announcements. Simple comparison of the average and median can hide the actual amount of variation in announcements. The actual average difference between 379 days and the actual announcement date is 0.15 years, or 55 days, as shown in the third row of Table 2. In this case the median is noticeably shorter, at 0.11 years, or 40 days. The higher average suggests that we are dealing with “fat tail” distribution of actual reporting periods around the mean.

Ideally, one would prefer no absolute difference in in the days on which RQ information is released. Stated another way, it would be ideal if the announcements were all on the same day of the year. Annualizing returns would not be necessary in such a case. However, the one instance of this occurring is a statistical artifact, created by beginning the contemporaneous period one year before the first announcement (i.e., on September 22, 1998). The maximum time between announcements was the 507 days between the initial announcement and the second RQ report publication on February 7, 2001. The minimum time lapse between RQ announcements was 0.70 years, as reported in the bottom row of Table 2. In 2004, RQ-related press releases occurred on February 19 and November 15 of the same year.

### **Performance Measures**

Returns based only on prices and total returns based on both prices and dividends, are computed for individual firms. Firm returns are equally weighted to create portfolio returns. Both return streams were identified in order to detect any ability of dividends to impact firm reputation beyond that which would arise from stock price-based returns alone. Firms with worse reputations may offer a higher dividend yield in order to attract investors. For instance, near the end of the empirical sample, dividend yields in the tobacco industry ranged from 5.46% at Lorillard to 3.92% at Philip Morris (Maurer, 2012). Philip Morris showed up frequently in the BOT10 portfolio, while the less well known Lorillard seldom made the list of 60 firm RQ ratings reported by Harris Interactive.

Mean, median, and geometric means are computed with the latter two being measured due to the limited sample and large difference in return volatility, respectively. Risk-adjusted returns were estimated using Sharpe ratios to estimate returns in excess of

the risk-free rate per unit of total risk, which is estimated using standard deviation. Treynor ratios measure returns in excess of the risk-free rate per unit of systematic risk, while Jensen's alphas measures are estimates of return in excess of what is required based upon the risk-free rate, market return, and systematic risk. The three measures were computed in the traditional way using the following equations. .

$$\text{Sharpe ratio} = (R_i - R_f) / \sigma$$

$$\text{Treynor ratio} = (R_i - R_f) / \beta$$

$$\text{Jensen's alpha} = R_i - R_f - \beta (R_m - R_f)$$

Where,

$\beta$  = a measure of systematic risk, using five years of data and the Standard & Poor's 500 as the measure of market returns.

$R_f$  = annualized combination of rolling three-month Treasury bill yields during the period between HQ announcements, weighted for the portion of the month during which RQ announcement is made

$R_i$  = annualized portfolio return between RQ announcement dates which may include dividends when  $R_i$  is a total return measure

$R_m$  = annualized return on the Standard and Poor's 500, with and without the dividend yield, depending upon the form of the  $R_i$  term

$\sigma_i$  = standard deviation of the portfolio return

Pairwise t-tests are run to compare the mean return and estimated risk-adjusted return measure for the two independent TOP10 and BOT10 portfolios in a manner done in the prior research (Krueger and Wrolstad (2009) and Krueger Wrolstad and Van Dalsem (2010)). The null hypothesis is that the high RQ and low RQ portfolios earned the same rate of return. The tables below present t-statistic p-values, giving the reader insight to the probability of rejecting a correct null hypothesis of firm reputation being independent of contemporaneous stock prices.

## FINDINGS

### Contemporaneous Returns

**Prices alone.** During the period when reputation data is being acquired, the mean price-based return earned by firms with the ten worst reputations (i.e., the “Bottom Ten (BOT10) portfolio) is higher than that earned by the ten firms with the highest RQ (TOP10). As exhibited in Table 3, in the first row of the price-based return columns the mean returns for the BOT10 portfolios are 2.92 percent (i.e., 16.44% - 13.52%) higher than the TOP10 portfolios. However, the difference is not significant. Geometric returns are 1.08 percent (i.e., 13.04% - 11.96%) higher, while the median returns register the largest difference in favor of the BOT10 portfolio at 3.23 percent (i.e., 17.66%- 14.43%).

The maximum total return of the BOT10 portfolio is 85.96 percent, as displayed on the fifth row of Table 3. This return was earned in 1999. In the first year a limited number of companies were measured and given an RQ rating by Harris Interactive, making this result potentially an artifact of the RQ process more than an indication of what to expect from firms with poor reputations. However, there were ten other firms chosen in that year which were identified as those with a better reputation. The next highest return by the BOT10 portfolio was the 35.0 percent gain by firms listed as having the lowest reputations in 2004. The BOT10’s worst total return performance was a loss of 34.86 percent, which is over ten percent worse than the TOP10’s -24.33 percent worst performance. There is also a ten percent difference in return standard deviations, which is consistent with the fact that the BOT10 portfolio has the highest and lowest returns and the insignificant difference in means returns despite the BOT10 portfolio’s much larger mean.

Contemporaneous share price performance does not appear to have much of an impact on firm reputation. (Note, although we are using the term “year” here for ease of reading, the actual period between announcements varies dramatically as shown in Table 2.)

**Total returns.** Including dividends results in the values presented in the “Total Returns” columns of Table 3. Comparing the total return to the price-based return calculated values, one sees the relative performance of the BOT10 portfolio increasing. The difference in mean returns rises to 5.03 percent (i.e., 20.50% - 15.47%), which is over two percent higher than the price based return (i.e., the 2.92% identified above). This increase suggests that per dollar invested BOT10 firms provide a higher dividend payment. However, the mean total return difference is not statistically significant.

Geometric total mean returns for the BOT10 portfolio exceed the TOP10 portfolio by 3.56 percent, while the median return values are 3.91 percent higher. Both of these statistics are higher when returns are based on dividends and share prices, which reinforce the finding that firms with lower reputations tend to offer higher dividends; perhaps as a way to placate investors. The maximum and minimum return values both rise, as would be expected with the inclusion of dividends. During its best period, dividends add another 2.42 percent to TOP10 portfolio returns, while during its worst period dividends reduce the loss by 1.48 percent. Across these two years the dividend yield is similar, averaging about 1.95 percent. During the best period, dividends add another 1.01 percent to BOT10 portfolio returns while during its worst period dividends reduce the loss by 7.74 percent. Reducing the value of company assets by the payment of a large dividend, may have offset to some extent an otherwise poor year for this portfolio. Across the two outlying periods, BOT10 portfolio dividends average 4.38 percent. This is 2.43 more than the TOP10 portfolio. The larger dividend payments of the BOT10 portfolio tends to dampen the variation of their returns but there still is a difference of 9.22 percent.

**Systematic risk.** Beta statistics are reported in Table 4, where one can see that while TOP10 portfolio firms tend to have defensive betas BOT10 portfolio firms are much more sensitivity to market movement. In fact, the BOT10 portfolio betas are 68 percent larger, which is statistically different at the 0.01 level. Hence, the BOT10 portfolios are required to earn 68 percent more than the market risk premium in order to justify taking the higher systematic risk. By contrast, the TOP10 portfolio return needs only 86.1 percent of the market risk premium to justify its level of systematic risk. The systematic risk difference is significant at the 0.01 level, meaning that with a ninety-nine percent level of confidence one can assert that firms with better reputations are less sensitivity to market conditions, which is consistent with the research of Pfarrer, Pollack, and Rindova (2010) mentioned above who documented that firms with good reputations experience a greater stock price reaction to good news and less of a penalty for bad news. Investors aversion to market corrections undoubtedly account for much of the aversion to firms with lesser reputations.

Other values in Table 4 reinforce the interpretation that firms with poor reputations have higher levels of systematic risk. Median values are close to mean values suggesting that there is a limited amount of skewness in the portfolio beta values across the 14 observations. Across portfolio formations, the beta of the TOP10 portfolio ranged from 0.688 to 1.068, which is about two standard deviations from the mean. Meanwhile, the betas of the BOT10 portfolio range from a very aggressive 2.257 to market-mirroring 0.987 in individual years. Although there is a lot of variation in the BOT10 portfolio's beta measure, it barely overlaps the TOP10 portfolio's beta. Whether considering total

risk with standard deviation or systematic risk as measured with beta, BOT10 portfolios are much more risky.

Beta is typically measured by multiplying the ratio of the standard deviation of a security's return to the market return's standard deviation by the security's correlation in the market. Given that the market portfolio is identical for both the TOP10 and BOT10 portfolio, the higher beta is a consequence of a higher standard deviation, higher correlation, or both. Given that the standard deviation of the BOT10 portfolio is about fifty percent larger than that of the TOP10 portfolio and the BOT10 portfolio's beta is about fifty percent higher than the TOP10 portfolio's beta, it appears as though the correlation with the market for both portfolios is similar. It is the vastly different standard deviations that are causing the difference in beta. These return and risk findings are consistent with those of Krueger, Wrolstad, and Van Dalsem (2010).

### **Risk-adjusted Returns**

**Sharpe Measures of Total Risk.** The final three tables exhibit findings concerning risk-adjusted returns. This analysis is necessary because the BOT10 RQ portfolio has both the highest return and the greatest amount of risk. Table 5 exhibits total risk-adjusted return findings based on the Sharpe model, Table 6 exhibits systematic risk-adjusted findings based on the Treynor model, and Table 7 exhibits Jensen's alphas. The first row of each table reports results for the entire time period (i.e., all fourteen RQ reports); while the information in Panel B allows comparison of contemporaneous return performance during the data collection for the first seven RQ reports versus the last seven RQ reports. Statistical comparisons are made within the TOP10 and BOT10 portfolios as well as across these portfolios for both price and total returns. Stated another way, analyzes were conducted in terms of whether a given reputation-based portfolio's risk-adjusted performance varied over time and whether there was a difference in the risk-adjusted performance across reputations within each seven-year period

Across the entire time period, the TOP10 portfolio has the highest Sharpe values, as displayed in Panel A of Table 5. The difference in Sharpe measures is 0.107 (i.e.,  $0.605 - 0.498$ ), using price-based returns in excess of the return on short-term Treasury instruments. The difference drops to 0.036 (i.e.,  $0.698 - 0.662$ ) using total returns, which is not surprising given the higher dividend payments of the BOT10 portfolio firms. Neither is significant at the 0.10 level. The fifty percent difference in standard deviations (i.e.,  $((29.52\% + 28.48\%) \div 2 = 29.00\%)$  for the BOT10 portfolios versus  $19.14\%$   $((19.02\% + 19.26\%) \div 2)$ ) for the TOP10 portfolio) is sufficient to offset the apparent return-based advantages of investing in the BOT10 portfolio proffered in Table 3.

Scanning down the price-based columns of Table 5's Panel B, one observes that the TOP10 portfolio's Sharpe values were higher during the first seven years. Meanwhile the BOT10 portfolio produced higher Sharpe measures during the second seven-year period. During the first half of the sample period, the TOP10 firms earned the higher Sharpe values. The lowest value in Panel B is the 0.429 earned by BOT10 RQ firms during the first seven years, which is somewhat surprising given the limited number of firms followed in the initial RQ report. Many of the firms in first year's BOT10 portfolio were in the TOP10 portfolio in subsequent years including Amazon, Microsoft, and Sony. The 0.429 value suggests that the inclusion of the small sample 1999 survey in the data does not confound the results derived from the other RQ announcements. During the second seven-year period, the BOT10 portfolio's Sharpe-based total risk adjusted return measure is slightly higher (i.e.,  $0.603 - 0.526 = 0.077$ ). None of the differences are statistically significant.

Similar results exist when total return is being assessed, as displayed in the "Total Returns" section of Panel B. In comparison to the portfolio/time period combinations in the price-based columns, all respective Sharpe values are higher in the "Total Return" column, as would be expected given the addition of dividend income in the Sharpe model's numerator. None of the t-statistics are significant; indicating the perceptions regarding firm reputation are not a function of contemporaneous risk-adjusted returns as measured by the Sharpe model.

**Treynor measures.** Treasury-excess returns, when adjusted for systematic risk using the Treynor model do not appear to dictate perceptions about firm reputations either. Although the TOP10 portfolio's Treynor measure is 3.61 percent (i.e.,  $14.24\% - 10.63\%$ ) higher, as reported in the first two columns of Table 6's Panel A, the difference is statistically insignificant. Unlike the Sharpe model results above, Treynor model values were higher for the TOP10 firms in the second seven-year period. The TOP10 portfolio's 15.67 percent Treynor measure in the last seven-year period is higher than the first seven years and the BOT10 portfolio's value in either time period. However, the volatility of price-based returns results in a lack of significance.

Paralleling findings presented in Table 5, each of the values in the "Total Returns" columns of Table 6's Panel A exceeds its corresponding value in the "Price-Based Returns" columns. TOP10 portfolio Treynor measures for total returns are almost three units higher than those of the BOT10 portfolio. However, the difference is not statistically significant. As shown in Table 6's Panel B, during the first seven years, the BOT10 portfolio's Treynor measure is 19.07 percent, despite the higher systematic risk of the BOT10 portfolio. This is double the rate during the second seven years sub-period,

and one-fourth larger than the Treynor measure of the TOP10 portfolio during the first seven years. The market appears to be properly incorporating the value of corporate reputation prior to the year in which reputation information is gathered from the public, eliminating the possibility of a contemporaneous relationship between firm reputation and systematic risk-adjusted returns as measured by the Treynor measure or looking beyond the pale of current stock price performance.

**Jensen's Alpha.** Jensen's alpha goes beyond measuring return in excess of Treasury yields per unit of systematic risk to consider return relative to the required rate of return in light of market performance. Both the Treasury yield and market risk premium times the level of systematic risk is subtracted from portfolio returns. This adjustment of return in light of the overall stock market performance with adjustment for the amount of systematic risk is the reason Jensen alphas are widely reported. Values reported in Table 7 can be viewed as annualized portfolio returns in excess of that required when the capital asset pricing model (CAPM) is used to estimate required return. Investments earning exactly the required rate of return would have a Jensen's alpha value of zero.

Both the TOP10 and BOT10 portfolio outperformed the required rate of return during the entire fourteen years, as shown in the first two columns of Table 7's Panel A. The TOP10 portfolio's annualized excess price-based return was 2.93 percent (i.e., 7.68% - 4.75%) higher, but insignificant at the 0.10 level. During the first seven years, the TOP10's portfolio outperformed the required rate of return by 9.66% on an annualized basis. This excess performance declined to 5.70% during the second half of the sample period, but the decline was not statistically significant.

In contrast, there was a significant decline in the BOT10 portfolio's alpha measure. The excess return dropped from 13.15% above the required return to 3.66% below the required rate of return. The difference has a p-value of 0.057, or there is about a six percent chance of the conclusion that BOT10 alpha values were different being incorrect. The TOP10 portfolio also declined, though not as precipitously. Hence, the alpha values of the TOP10 portfolio and BOT10 portfolio were not significantly different in either seven-year period.

Jensen's alpha measures have a similar pattern when total returns replace price-based returns as the independent variable. TOP10 RQ firms outperform BOT10 RQ firms after adjusting for the CAPM-based estimate of the required return by 2.07 percent (i.e., 8.04% - 5.97%). However, the BOT10 portfolio had the highest Jensen alpha (i.e., 16.94%) during the first seven years. There is a drop of 21.94 percent in the Jensen alpha measure from the first half to the second half of the sample period. This difference is

significant at the 0.05 level. Neither the drop in the TOP10 portfolio alpha value or the TOP10 versus BOT10 portfolio alpha values within any given period is significant. In almost all instances, the findings support the null hypothesis that contemporaneous return performance of companies is not used to adjudicate their reputations.

## SUMMARY

Past research and common perceptions hold that a positive corporate reputation is a valuable asset. When investors perceive companies have mishandled the trust placed in them, the stock price reaction can be abrupt and devastating. BP, Enron, and Volkswagen are just a few of the companies that experienced a rapid decline in stock price when their reputations sank following events like the Deepwater Horizon explosion, accounting fraud, and the recent diesel emissions scandal, respectively. However, these could be outliers due to the atypical horrific nature of the event. Under typical circumstances, investors may adjust firm perceptions of investment attractiveness based upon current share price performance. Alternatively, they may look to the long-run anticipated performance, looking beyond the pale of observed short-term price movements. This ambiguity presents an empirical question as to whether firm reputations are based upon firm fundamentals and actions or more narrowly share price performance, or possibly both. Is it possible that a contemporaneous link exists between corporate reputation and stock price performance? This issue is the empirical question this research sought to address.

In order to investigate this issue, we studied the performance of the companies with the best and worst reputations during a period when reputations were being rigorously measured. For purposes of this research, corporate reputations levels are assumed to be accurately measured by Harris Interactive, Inc. which went through an exhaustive process to measure reputations quotients (RQs). In the typical year, the RQs of sixty companies are published. In order to measure the relative performance of good and bad reputations, we chose the ten companies with the highest and lowest reputation quotients.

Our analysis contributes to the general body of knowledge regarding corporate reputation in several ways. One, we annualize returns to eliminate one potentially confounding factor originating from prior research which simply measured performance over the coming year or performance from RQ announcement to RQ announcement without adjustment for the actual interval. Two, we use all of the RQ data available during the period before Harris Interactive was acquired by Nielson Holdings. Three, we consider multiple measures of return, risk and risk-adjusted return.

Our findings indicate that stock price performance plays a minor role in the setting of firm reputations. In fact, during the period that individuals were being questioned about firm reputations, firms with low reputations typically earned higher returns than firms with high reputations. This finding is consistent with the bottom line backlash effect proposed by Porritt (2005). However, low RQ firms also had higher risk. After adjusting for risk, firms with high RQs had higher risk-adjusted returns whether risk was measured using standard deviation or beta. Jensen alpha measures were also higher for the high RQ firm portfolio. However, the differences were not statistically significant. A highly significant finding was that firms with poor reputations experienced a significant drop in Jensen's alpha during the period that included the 2008 financial crisis. The poor returns of these companies, relative to required returns given their systematic risk and market performance, may be a metric used by individuals in gauging company reputation.

There are several ways in which this research can be extended. One, analysis of firm's post-RQ announcement investment performance would allow assessment of the investment value of information about firm reputation. Two, changes in perceptions regarding a firm's reputation may be related to changes in share prices and might be helpful in explaining current share price as well as predicting future stock prices. Three, similar research using other measures of firm reputation will enhance our understanding of the relationship between corporate reputation and firm value. Finally, it may be useful to start with firms experiencing large share price adjustments and see if there is a relevant concurrent change in corporate reputation.

<b>Table 1. Firms with Reputation Quotients not included in Study</b>			
Firm	RQ Year	Why Excluded	Year of Event
<b>Top 10 Firms</b>			
SC Johnson	2010	Always private	not applicable
<b>Bottom 10 Firms</b>			
MCI Communications (WorldCom)	2002,2006	Bankrupt	2002
Bridgestone Tire	2003	Acquired by Firestone	1988
Adelphia Communications	2003, 2005, 2006	Bankrupt	2002
Global Crossing	2004	Bankrupt	2002
Enron	2006	Bankrupt	2001
Northwest Airlines	2008	Acquired by Delta	2005
Citgo Petroleum	2008,2009	Acquired by Petroleos de Venezuela	1990
Chrysler	2008, 2009, 2010, 2011	Acquired by Cerberus	2008
Merrill Lynch	2009	Acquired by Bank of America	2009
General Motors	2009, 2010	Bankrupt	2009

<b>Table 2. Analysis of Variation in Reputation Quotient Announcement Dates</b>		
Average Time Period Between RQ Announcements	1.04 years	379 days
Median Time Period Between RQ Announcements	1.02 years	371 days
Average Absolute Excess Sample Period Length	0.15 years	55 days
Median Absolute Excess Sample Period Length	0.11 years	40 days
Minimum Absolute Excess Sample Period Length	0.00 years	0 days
Maximum Time Between RQ Announcements	1.39 years	507 days
Minimum Time Between RQ Announcements	0.70 years	256 days

<b>Table 3. Contemporaneous Return Characteristics</b>				
	Price-based Returns		Total Returns	
	Top 10 Portfolio	Bottom 10 Portfolio	Top 10 Portfolio	Bottom 10 Portfolio
Mean Return	13.52%	16.44%	15.47%	20.50%
t-statistic p values	0.321		0.205	
Geometric Return	11.96%	13.04%	13.90%	17.46%
Median Return	14.43%	17.66%	18.04%	21.95%
Maximum Return	48.78%	85.96%	51.20%	86.97%
Minimum Return	-24.33%	-34.86%	-22.85%	-27.12%
Return Standard Deviation	19.02%	29.52%	19.26%	28.48%

<b>Table 4. Detailed Analysis of Portfolio Beta</b>		
	Top 10 Portfolio	Bottom 10 Portfolio
Average	0.861	1.449
t-statistic p values	0.001***	
Median	0.838	1.411
Maximum	1.068	2.257
Minimum	0.688	0.987
Standard Deviation	0.101	0.338

\*, \*\*, \*\*\* indicates significance at the 0.10, 0.05, and 0.01 levels, respectively.

<b>Table 5. Sharpe Measure Estimates of Total Risk Adjusted Contemporaneous Returns</b>						
	Price-Based Returns			Total Returns		
Panel A. Entire Sample Period	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios
	0.605	0.498	0.389	0.698	0.662	0.439
Panel B. Subsample						
First 7 Years	0.670	0.429	0.428	0.775	0.617	0.368
Second 7 Years	0.526	0.603	0.350	0.605	0.730	0.355
t-statistic p values Across Time Periods	0.479	0.449	na	0.482	0.372	na

<b>Table 6. Treynor Measure Estimates of Systematic Risk Adjusted Contemporaneous Returns</b>						
	Price-Based Returns			Total Returns		
Panel A: Entire Sample Period	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios
	14.24	10.63	0.207	16.58	13.69	0.343
Panel B: Subsample						
First 7 Years	12.81	14.57	0.426	15.05	19.07	0.328
Second 7 Years	15.67	6.70	0.222	18.12	8.03	0.208
t-statistic p values Across Time Periods	0.422	0.303	na	0.418	0.334	Na

<b>Table 7. Jensen's alpha Measures of Systematic Risk-Adjusted Contemporaneous Returns</b>						
	Price-Based Returns			Total Returns		
Panel A. Entire Sample Period	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios	Top 10 Portfolio	Bottom 10 Portfolio	t-statistic p values Across Portfolios
	7.68%	4.75%	0.338	8.04%	5.97%	0.400
Panel B. Subsample						
First 7 Years	9.66%	13.15%	0.355	10.20%	16.94%	0.222
Second 7 Years	5.70%	-3.66%	0.244	5.87%	-5.00%	0.216
t-statistic p values Across Time Periods	0.249	0.057*	na	0.224	0.018**	na

\*, \*\*, \*\*\* indicates significance at the 0.10, 0.05, and 0.01 levels, respectively.

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## BENEFIT CORPORATIONS: FOSTERING SOCIALLY CONSCIOUS CORPORATE LEADERSHIP

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In the modern business world corporate social responsibility competes with sexuality for top billing in corporate marketing.<sup>1</sup> Unfortunately, this high priority for corporate social responsibility seems more a matter of form than substance. While the consideration of social, environmental, and ethical issues lies center stage in business discourse, genuine progress continues to advance at a glacial rate. Despite estimates that over 2 million organizations work to promote social justice and environmental sustainability,<sup>2</sup> multinational corporations continue to wreak havoc with debatable levels of accountability. In light of such a limited track record of success, as well as the social, economic, political, and cultural differences throughout the globe, the central question driving this article is as follows: Is it possible to foster a worldwide business environment where social enterprise reflects a common business practice rather than a notable exception to the rule of profits before people and planet?

We believe that the answer to this question is yes, and that one of the vehicles may drive such change is an emerging and innovative type of business entity, the social enterprise. Numerous countries, including the United States, Canada, United Kingdom, France, Germany, Italy, Japan, and Russia, have already enacted legislation in support of social enterprise business entities.<sup>3</sup> Despite the voluntary nature of social enterprise legislation, the emergence of such legislation has the potential to catalyze new expectations and efforts for behavioral change, paving the way for a new paradigm in business behavior.<sup>4</sup>

We begin with a discussion centered on the traditional viewpoint that multinational corporations primarily creates social problems by briefly examining corporate social rights abuses, the shortcomings of existing regulation, corporate lobbying efforts, and the social impact of increased regulation. Next, we explore the growing strength behind a central challenge to the traditional viewpoint: multinational corporations can solve social problems. We then examine how socially conscious leadership and social enterprise provide a means for reexamining the dichotomy between the traditional viewpoint and contemporary business practices. Finally, we discuss the attributes of a specific social enterprise, the benefit corporation, followed by an

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<sup>1</sup> JOEL BAKAN, *THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER* (2004).

<sup>2</sup> PAUL HAWKEN, *BLESSED UNREST: HOW THE LARGEST SOCIAL MOVEMENT IN HISTORY IS RESTORING GRACE, JUSTICE AND BEAUTY TO THE WORLD* (2007).

<sup>3</sup> Orrick, Herrington & Sutcliffe LLP, *Balancing Purpose and Profit: Legal Mechanisms to Lock in Social Mission for "Profit with Purpose" Businesses across the G8* (December 2014), <http://www.trust.org/contentAsset/raw-data/1d3b4f99-2a65-49f9-9bc0-39585bc52cac/file>

<sup>4</sup> Regina Robson, *A New Look at Benefit Corporations: Game Theory and Game Changer*, 52 AM. BUS. L. J. 501, 501 (2015).

assessment of the entity's development potential on an international scale. We conclude with suggestions for future research.

## The Traditional Viewpoint: Businesses Create Social Problems

### Corporate Social Rights Abuses

There is extensive evidence with the academic literature to support the traditional viewpoint that multinational corporations only generate social evils.<sup>5</sup> Academic scholarship and the business press are besieged by examples of gross corporate malfeasance, including the mining of conflict minerals in the Congo by cell phone manufacturers, the practice of sweatshop labor in Bangladeshi garment factories, and the censorship of internet usage in diverse countries throughout the world.<sup>6</sup> In a similar fashion, there is an abundant array of evidentiary support to the contention that humans are destroying the environment.<sup>7</sup> Humanity takes the abundance of Earth's natural resources for granted, as modern humans have the same environmental impact in five minutes that early humans had in one year.<sup>8</sup>

The world economy possesses numerous characteristics of a Ponzi scheme, for economic development now overtakes the Earth's sustainable yield capacity by 30%.<sup>9</sup> Industrial polluters discharge thousands of pounds of toxic waste into the atmosphere and water system.<sup>10</sup> The destructive social and ecological concerns that derive from global corporate activities are the recipients of an upward momentum of disapproval and condemnation from social rights

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<sup>5</sup> SURYA DEVA, REGULATING CORPORATE HUMAN RIGHTS VIOLATIONS: HUMANIZING BUSINESS (2012); Florian Wettstein, *Silence as Complicity: Elements of a Corporate Duty to Speak out against the Violation of Human Rights*, 22 BUS. ETH. QUART. 37 (2012); Nicola Jägers, Katinka Jesse, & Jonathan Verschuuren, *The Future of Corporate Liability for Extraterritorial Human Rights Abuses: The Dutch Case against Shell*, AM. J. INT'L. L. 601 (2013); Sarah Coleman & Jonathan Friedler, *Road to Reform in the Wake of Kiobel: Multinational Corporations and Socially Responsible Behavior*, 13 J. INT'L BUS. & L. 191 (2014); Shuili Du & Edward T. Vieira Jr., *Striving for Legitimacy through Corporate Social Responsibility: Insights from Oil Companies*, 110 J. BUS. ETH. 413 (2012); Stepan Wood, *The Case for Leverage-Based Corporate Human Rights Responsibility*, 22 BUS. ETH. QUART. 63 (2012); Nadia Bernaz, *Enhancing Corporate Accountability for Human Rights Violations: Is Extraterritoriality the Magic Potion?* 117 J. BUS. ETH. 493 (2013).

<sup>6</sup> Christine Bader, *Companies Commit Human-Rights Abuses in America, too* (May 28, 2014),

<http://www.theatlantic.com/business/archive/2014/05/human-rights-abuses-happen-in-america-too/371702/>

<sup>7</sup> ANDREW GOUDIE, THE HUMAN IMPACT ON THE NATURAL ENVIRONMENT: PAST, PRESENT, AND FUTURE (2013); ANDREW GOUDIE & HEATHER VILES, THE EARTH TRANSFORMED: AN INTRODUCTION TO HUMAN IMPACTS ON THE ENVIRONMENT (2013); ELIZABETH K. BERNER & ROBERT A. BERNER, GLOBAL ENVIRONMENT: WATER, AIR, AND GEOCHEMICAL CYCLES (2012); Jorge E. Hardoy & David Satterthwaite, *Environmental Problems of Third World Cities: A Global Issue Ignored?* CITIES OF THE GLOBAL SOUTH READER.155 (2014); Alessandro Galli, Thomas Wiedmann, Ertug Ercin, Doris Knoblauch, Brad Ewing, & Stefan Giljum, *Integrating Ecological, Carbon and Water Footprint into a "Footprint Family" of Indicators: Definition and Role in Tracking Human Pressure on the Planet*. 16 ECOL. INDIC. 100 (2012); Charles Vörösmarty, Claudia Pahl-Wostl, Stuart Bunn, & Richard Lawford, *Global Water, the Anthropocene and the Transformation of a Science*, 5 CURRENT OPINION IN ENVIRONMENTAL SUSTAINABILITY. 539 (2013).

<sup>8</sup> See Hawken, *supra* note 2.

<sup>9</sup> LESTER R. BROWN, PLAN B 4.0: MOBILIZING EARTH TO SAVE CIVILIZATION (2009).

<sup>10</sup> Nathalie Cely, *Balancing Profit and Environmental Sustainability in Ecuador: Lessons Learned from the Chevron Case*. 24 DUKE ENVIRON. LAW & POL. 24 (2014); Cyril U. Gwam, *Human Rights Implications of Illicit Toxic Waste Dumping from Developing Countries Including the USA, Especially Texas to Africa, in Particular, Nigeria*. 38 T. MARSHALL L. REV., 242 (2012).

advocates.<sup>11</sup> Multinational corporations (MNCs) are involved routinely in assorted social cruelties, including environmental pollution, the disregard of domestic laws, and bribery. Companies in the extractive industries constitute several of the most high-volume wrongdoers.<sup>12</sup> For example, Royal Dutch Shell recently faced accusations of using paramilitary forces in conjunction with the torture and arbitrary arrest of Nigerian citizens.<sup>13</sup> Similarly, food producers spend billions of dollars on the promotion of consumer products that contain pesticides, contaminants, and synthetic preservatives, ingredients that lead to heart disease, liver disease, and cancer.<sup>14</sup> Even developed countries such as the United States, child tobacco workers use dangerous machinery, toil in extreme heat, and risk exposure to toxic pesticides and nicotine in an effort to provide the world's largest cigarette companies with tobacco.<sup>15</sup> Other concerns relate to unsafe working conditions,<sup>16</sup> income inequality,<sup>17</sup> and employee strain.<sup>18</sup>

### The Shortcomings of Existing Regulation

In light of such diverse challenges, segments of the academic community assert that increased regulation may not necessarily mitigate or eliminate corporate abuses.<sup>19</sup> Unfortunately, a regulatory solution is problematic on multiple levels. At the international level, environmental, social and human rights treaties and conventions do not apply to business

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<sup>11</sup> Ken McPhail, *Corporate Responsibility to Respect Human Rights and Business Schools' Responsibility to Teach it: Incorporating Human Rights into the Sustainability Agenda*, 22 ACCOUNTING EDUC. 391 (2013); Andreas G. Scherer & Guido Palazzo, *The New Political Role of Business in a Globalized World: A Review of a New Perspective on CSR and its Implications for the Firm, Governance, and Democracy*, 48 J. MGMT. STUD. 899 (2011).

<sup>12</sup> Denis G. Arnold, *Transnational Corporations and the Duty to Respect Basic Human Rights*, 20 BUS. ETH. QUART. 371, 371 (2010).

<sup>13</sup> *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659, 185 L. Ed. 2d 671 (2013).

<sup>14</sup> TED, *Michael Porter: The Case for Letting Business Solve Social Problems* (June, 2013), [http://www.ted.com/talks/michael\\_porter\\_why\\_business\\_can\\_be\\_good\\_at\\_solving\\_social\\_problems.html](http://www.ted.com/talks/michael_porter_why_business_can_be_good_at_solving_social_problems.html)

<sup>15</sup> See, e.g., *Tobacco's Hidden Children: Hazardous Child Labor in United States Tobacco Farming* (May 13, 2014), [https://www.hrw.org/sites/default/files/reports/us0514\\_upload\\_newnew.pdf](https://www.hrw.org/sites/default/files/reports/us0514_upload_newnew.pdf)

<sup>16</sup> Jason R. Bent, *Incentive-based Approach to Regulating Workplace Chemicals*, 73 OHIO ST. L. J., 1391 (2012); Zachary S. Price, *Politics of Nonenforcement*, 65 CASE W. RES. L. REV., 1120 (2014).

<sup>17</sup> Fahd Ahmed, Tom Angotti, Jennifer J. Austin, Shawn Blumberg, & Robin Steinberg, *Long Crisis: Economic Inequality in New York City*, 18 CUNY L. REV. 154 (2014); Adam Gopnik, *Market man: What did Adam Smith really believe?* (October 18, 2010), <http://www.newyorker.com/magazine/2010/10/18/market-man>; Zaid Jilani, *How unequal we are: The top 5 facts you should know about the wealthiest one percent of Americans*. (October 3, 2011), <http://thinkprogress.org/economy/2011/10/03/334156/top-five-wealthiest-one-percent/>

<sup>18</sup> Odunayo T Arogundade & Ayodeji B. Arogundade, *Psychological Empowerment in the Workplace: Implications for Employees' Career Satisfaction*, 17 N. AMER. J. PSYCH. 27 (2015); Naser I. Saif & Afnan S. Saleh, *Psychological Empowerment and Job Satisfaction in Jordanian Hospitals*, 3 INTL. J. HUM. & SOC. SCI. 250 (2013).

<sup>19</sup> Kate Litvak, *Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-Taking*, U. ILL. L. REV. 1663 (2014); Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 1 (2012); Jeanette M. Franzel, *A Decade after Sarbanes-Oxley: The Need for Ongoing Vigilance, Monitoring, and Research*, 28 ACCOUNTING HORIZONS. 917 (2014); Mustafa Dah, Melissa Frye, & Matthew Hurst, *Board Changes and CEO Turnover: The Unanticipated Effects of the Sarbanes-Oxley Act*, 41 J. BANK. & FIN. 97 (2014); Anthony Basile, Sheila Handy, & Felisha Fret, *A Retrospective Look at the Sarbanes-Oxley Act of 2002-Has it Accomplished its Original Purpose?* 31 J. APP. BUS. RSCH. 585 (2015).

entities.<sup>20</sup> As non-state actors, corporations are not subject to international law.<sup>21</sup> At the national level, domestic legislation has a narrow impact on ecological and social externalities.<sup>22</sup> Efforts to subvert corporate mistreatment and exploitation have failed as a result of pitiful enforcement in developing countries.<sup>23</sup> In no small measure, the monetary benefits of foreign direct investment (FDI) foster a mood of political reticence with respect to the oversight of MNCs local operations.<sup>24</sup> For instance, Coke and Pepsi produce their concentrates in Singapore and Ireland respectively due to profitable tax policies.<sup>25</sup>

The situation is no better in the United States. The country's inadequate and ineffectual regulations permit corporations to expose individuals and the atmosphere to harm without concern for severe legal penalties.<sup>26</sup> For instance, while nearly 80,000 chemicals are utilized in modern industrial commerce, the Occupational Safety and Health Administration (OSHA) regulates approximately 500 chemicals.<sup>27</sup> In addition, OSHA has faced allegations that the administration's leadership intentionally changed inspection practices and reduced inspectors' authority to issue certain citations.<sup>28</sup> As a result of limited agency resources, on-site inspections are comparatively infrequent and infraction fines are relatively small.<sup>29</sup> Similarly, subsequent to the 2001 Enron scandal, the country's federal prosecutors have faltered in filing significant criminal charges against companies that are judged critical to the domestic economy, popularly referred to as the Andersen Effect. In place of formal criminal charges, the Department of Justice relies on consent decrees, non-prosecution agreements, and deferred prosecution agreements.<sup>30</sup>

## Corporate Lobbying Efforts

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<sup>20</sup> Treaties and conventions related to environmental preservation include the Vienna Convention for the Protection of the Ozone Layer, the Convention on Biological Diversity, the Convention on the Conservation of Migratory Species of Wild Animals, and the Kyoto Protocol. Treaties and conventions related to the preservation of social and human rights include the International Covenant on Civil and Political Rights (ICCPR), the International Covenant on Economic, Social, and Cultural Rights (ICESCR), the Convention on the Rights of the Child (CRC), the Convention Against Torture (CAT), the Convention on the Elimination of All Forms of Racial Discrimination (ICERD), and the Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW).

<sup>21</sup> Edmund F. Byrne, *In Lieu of a Sovereignty Shield, Multinational Corporations should be Responsible for the Harm they Cause*. 124 J. BUS. ETH. 609 (2014); Florian Wettstein, *CSR and the Debate on Business and Human Rights: Bridging the Great Divide*, 22 BUS. ETH. QUART, 739 (2012).

<sup>22</sup> Sebastien Mena & Guido Palazzo, *Input and Output Legitimacy of Multi-Stakeholder Initiatives*, 22 BUS. ETH. QUART. 527 (2012).

<sup>23</sup> Robert McCorquodale, *Corporate Social Responsibility and International Human Rights Law*, 87 J. BUS. ETH. 385 (2009).

<sup>24</sup> Denis G. Arnold, *Global Justice and International Business*. 23 BUS. ETH. QUART. 125 (2013); McPhail, *supra* note 11.

<sup>25</sup> Byrne, *supra* note 21.

<sup>26</sup> Marjorie Kelly, *Not Just for Profit* (February 26, 2009), <http://www.strategy-business.com/media/file/enews-02-26-09.pdf>; Joan Martinez-Alier, Unai Pascual, Franck-Dominique Vivien, & Edwin Zaccai, *Sustainable De-growth: Mapping the Context, Criticisms and Future Prospects of an Emergent Paradigm*. 69 ECOLOGICAL ECONOMICS, 1741 (2010); Roxana M. Pivodă, *Challenges and Risks to Manage Sustainability throughout the Value Chain*, 4 ECON. MGMT. & FIN. MARKTS. 296 (2014).

<sup>27</sup> Bent, *supra* note 16.

<sup>28</sup> Price, *supra* note 16.

<sup>29</sup> Bent, *supra* note 16.

<sup>30</sup> Byrne, *supra* note 21.

Previous efforts to produce augmented legal responsibility for corporate cruelties and atrocities have nose-dived largely due to robust resistance stemming from the business community.<sup>31</sup> The distinctive blend of enormous capital and insufficient legal parameters empowers international corporations to discard opposition, manipulate market prices, and influence legislative administration.<sup>32</sup> Companies spend large sums of money on lobbying services from firms that maintain a strong connection to legislators based on the presumption that such a connection will accrue greater firm value.<sup>33</sup> For example, companies in the pharmaceutical industry lobbied extensively during the 2000s in support of proposed reforms to limit pharmaceutical accountability for mislabeled drugs.<sup>34</sup> With the support of the National Rifle Association (NRA), advocates in the \$12-billion-a-year gun industry influenced politicians to enact legislation in support of an anti-gun control agenda.<sup>35</sup> Specifically, the firearms industry and the NRA have collectively dispensed over \$80 million into Senate, House, and presidential races since the 2000 election.<sup>36</sup>

Additionally, there is growing evidence that major corporations endeavor to subvert environmental conservation initiatives. For example, Exxon Mobil (Exxon) has lobbied against CO<sub>2</sub> reduction legislation for years. A recent examination of the scholarly literature revealed that Exxon has a connection to 9 of the 10 most heavily cited articles on the topic of opposition to climate change.<sup>37</sup> Moreover, Exxon is currently under investigation by the New York Attorney General for allegedly concealing information from shareholders and the general public relative to the dangers of climate change.<sup>38</sup> Likewise, firms apportion superior resources to lobbying activities that have a connection with political action committees (PACs).<sup>39</sup> Finally, the likelihood of fraud detection has an inverse relationship to corporate lobbying efforts.<sup>40</sup> Consequently, there is evidence to suggest that unrestrained capitalistic philosophies are detrimental to social progress.<sup>41</sup>

### Increased Regulation Creates Social Problems

As indicated above, it will be difficult to eradicate all social crises through legal regulation alone. In fact, additional legislative oversight may aggravate social harm through the

<sup>31</sup> *Id.*

<sup>32</sup> Gopnik, *supra* note 17.

<sup>33</sup> Jordi B. Vidal, Mirko Draca, & Christian Fons-Rosen, *Revolving Door Lobbyists*, 102 AM. ECON. REV. 3731 (2012).

<sup>34</sup> Michael Zhang, *Current Trends in Tort Reform and Pharmaceuticals Manufacturers' Liability: Michigan's Combination Product Exception* (December 2, 2014), <http://stlr.org/2014/12/02/current-trends-in-tort-reform-and-pharmaceuticals-manufacturers-liability-michigans-combination-product-exception/>

<sup>35</sup> Peter H. Stone & Ben Hallman, *NRA Gun Control Crusade Reflects Firearms Industry Financial Ties* (January 11, 2013), [http://www.huffingtonpost.com/2013/01/11/nra-gun-control-firearms-industry-ties\\_n\\_2434142.html](http://www.huffingtonpost.com/2013/01/11/nra-gun-control-firearms-industry-ties_n_2434142.html)

<sup>36</sup> Alan Berlow & Gordon Witkin, *Gun Lobby's Money and Power still holds Sway over Congress* (May 1, 2013), <http://www.publicintegrity.org/2013/05/01/12591/gun-lobbys-money-and-power-still-holds-sway-over-congress>

<sup>37</sup> Mihai Andrei, *9 out of 10 Top Climate Change Deniers Linked with Exxon Mobil* (May 10, 2011), <http://www.zmescience.com/ecology/climate-change-papers-exxon-mobil/>

<sup>38</sup> Ahiza Garcia & Chris Isidore, *ExxonMobil hit with Climate Change Investigation in New York* (November 6, 2015), <http://money.cnn.com/2015/11/05/news/exxonmobil-climate-change-investigation/>

<sup>39</sup> Matthew D. Hill, Wayne G. Kelly, Brandon Lockhart, & Robert A. Van Ness, *Determinants and Effects of Corporate Lobbying*, 42 FIN. MGMT. 931 (2013).

<sup>40</sup> Frank Yu & Xiaoyun Yu, *Corporate Lobbying and Fraud Detection*. 46 J. FIN. & QUANT. ANALYSIS. 1865 (2011).

<sup>41</sup> Jennifer George, *Compassion and Capitalism: Implications for Organizational Studies*, 40 J. MGMT. 5 (2014).

conservation of an unfair capitalistic system that is driven by corporate monetary interests.<sup>42</sup> On the one hand, intellectual property law protects the patent ownership of genetically modified foods. For example, 86% of corn and 93% of soybeans in the United States stem from patented, genetically modified seeds.<sup>43</sup> Patent law affects the types of food Americans consume as well as the composition of the industry that produces such foods. Ultimately, agricultural biotechnology patents allow a small segment of patent owners, such as Monsanto and Syngenta, to influence what ends up on the plate of the consumer.<sup>44</sup> Monsanto, DuPont and Syngenta combined possess 53% of the worldwide commercial seed market and will go to great lengths to protect their investment.<sup>45</sup> As of January 2013, Monsanto had filed 144 patent infringement lawsuits against 410 farmers across 27 states.<sup>46</sup> Patent law enables corporations to monopolize the food system by turning a seed into a powerful commodity.<sup>47</sup> On the other hand, global hunger is growing at an exponential rate. Over 800 million people do not have adequate food necessary to sustain healthy living.<sup>48</sup> Therefore, it is necessary to ask whether it is moral and proper to place control over items that are indispensable to human life into the hands of a few corporations.<sup>49</sup>

By the same token, trade and tax regulations also exacerbate social problems. For example, international trade law may prohibit a country from crafting or implementing national or local regulations that seek to curb corporate cruelties. The World Trade Organization spurred the development of international bans on domestic laws that restrain international trade.<sup>50</sup> The World Trade Organization has employed its broad powers in the coercion of nations, resulting in the amendment or dissolution of human rights regulations that hinder global trade.<sup>51</sup> Similarly, United States tax regulations endorse wasteful resource practices while rebuking improvements to resource productivity. Regulated utilities are customarily remunerated for vending higher amounts of energy, water, and other natural resources.<sup>52</sup>

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<sup>42</sup> ODILIA OSAKWE & SYED A. A. RIZVI, SOCIAL ASPECTS OF DRUG DISCOVERY, DEVELOPMENT AND COMMERCIALIZATION (2016); Paul D. Jorgensen, *Pharmaceuticals, Political Money, and Public Policy: A Theoretical and Empirical Agenda*, 41 J. L. MED. & ETH. 561 (2013); Ahmed Tahoun, *The Role of Stock Ownership by US Members of Congress on the Market for Political Favors*, 111 J. FIN. ECON. 86 (2014); Maria M. Correia, *Political Connections and SEC Enforcement*, 57 J. ACCT. & ECON. 241 (2014); Marc A. Rodwin, *Introduction: Institutional corruption and the pharmaceutical policy*, 41 J. L. MED. & ETH. 544 (2013); Evan A. Peterson, Carletta E. Griffin, Gregory W. Ulferts, & Terry L. Howard, *Law, Business Strategy, and Social Change in the Global Environment*, 19 INT'L J. MGMT & INFO. SYS. 123 (2015);

<sup>43</sup> Katherine Paul & Ronnie Cummins, *GMO and the Corporate Patenting of Living Organisms: Monsanto's Patents on Life* (May 25, 2013), <http://www.globalresearch.ca/gmo-and-the-corporate-patenting-of-living-organisms-monsantos-patents-on-life/5324781>

<sup>44</sup> Elizabeth A. Rowe, *Patents, Genetically Modified Food, and IP Overreaching*, 64 SMUL. REV. 860 (2011).

<sup>45</sup> Rachel Tepper, *Seed Giants Sue U.S. Farmers over Genetically Modified Seed Patents in Shocking Numbers: Report* (February 13, 2013), [http://www.huffingtonpost.com/2013/02/13/genetically-modified-seed-patent-report\\_n\\_2678837.html](http://www.huffingtonpost.com/2013/02/13/genetically-modified-seed-patent-report_n_2678837.html)

<sup>46</sup> *Id.*

<sup>47</sup> Paul & Cummins, *supra* at note 43.

<sup>48</sup> Food and Agriculture Organization of the United Nations, *The state of food insecurity in the world 2014*, <http://www.fao.org/3/a-i4030e.pdf> (last visited December 8, 2015).

<sup>49</sup> Brown, *supra* note 9.

<sup>50</sup> Bakan, *supra* note 1.

<sup>51</sup> Tomer Broude & Holger P. Hestermeyer, *First Condition of Progress-Freedom of Speech and the Limits of International Trade Law*, 54 VA. J. INT'L L. 295 (2013-2014); Brian J. Safran, *A Critical Look at Western Perceptions of China's Intellectual Property System*, 3 U. PUERTO RICO BUS. L. J. 135 (2012).

<sup>52</sup> Amory B. Lovins, Hunter L. Lovins, & Paul Hawken, *A Road Map for Natural Capitalism*, 85 HARV. BUS. REV. 172, 172 (2007).

## The Challenge: Believing that Business can Solve Social Problems

Contemporary MNCs brandish an unparalleled level of wealth and power. Massive MNCs now thrive in geographic regions previously managed by state governments.<sup>53</sup> This conversion of responsibility derives from the increasing level of foreign direct investment by MNCs in developing countries.<sup>54</sup> The yearly sales revenue of numerous MNCs currently surpasses the GNP of many developed and developing countries.<sup>55</sup> Subsequently, there is support for the argument that MNCs now possess sovereignty powers.<sup>56</sup> By virtue of their sprawling influence and resources, corporations represent an essential source of social innovation.<sup>57</sup>

Despite condemnations that businesses have commandeered CSR practices principally for commercial rather than communal reasons,<sup>58</sup> there is mounting proof of recognition and acceptance of this duty from the corporate sector. The triple-bottom-line approach focused on the planet, people, and profit has collected budding encouragement in recent years.<sup>59</sup> A 2009 Google search revealed that over 1,480,000 web pages referenced the triple-bottom-line philosophy.<sup>60</sup> Nearly every single Fortune 500 company produces a corporate social responsibility report of one grade or another.<sup>61</sup> Moreover, although the subject of human rights has conventionally garnered limited attention in the CSR literature,<sup>62</sup> the increasing manifestation of human rights in cross-cultural dialogues on corporate accountability suggests a notable development in corporate governance practices. Over 50% of Fortune 100 companies have implemented an identifiable human rights policy.<sup>63</sup> Hence, MNCs now participate in self-regulatory practices by assimilating increased social and ecological measures in their worldwide operations.<sup>64</sup> Intricate guidelines and codes guide organizational behavior in practices in the prevention of human rights cruelties.<sup>65</sup>

<sup>53</sup> Shaomin Li & Ajai Gaur, *Financial Giants and Moral Pygmies? Multinational Corporations and Human Rights in Emerging Markets*, 9 INTL. J. EMERGING MRKTS. 11 (2014).

<sup>54</sup> McPhail, *supra* note 7.

<sup>55</sup> DEBRA JOHNSON AND COLIN TURNER, *INTERNATIONAL BUSINESS: THEMES AND ISSUES IN THE MODERN GLOBAL ECONOMY* (2010).

<sup>56</sup> Byrne, *supra* note 15; Wettstein, *supra* note 15.

<sup>57</sup> Management Innovation Exchange, *Gary Hamel: Reinventing the technology of human accomplishment* (November 6, 2015), <http://www.managementexchange.com/video/gary-hamel-reinventing-technology-human-accomplishment>; TED, *Michael Porter: Why business can be good at solving social problems* (November 6, 2015), [http://www.ted.com/talks/michael\\_porter\\_why\\_business\\_can\\_be\\_good\\_at\\_solving\\_social\\_problems.html](http://www.ted.com/talks/michael_porter_why_business_can_be_good_at_solving_social_problems.html)

<sup>58</sup> Jerry Carbo, Ian M. Langella, Viet T. Dao, & Steven J. Haase, *Breaking the Ties that Bind: From Corporate Sustainability to Socially Sustainable Systems*, 119 BUS. & SOC. REV. 175 (2014); Maretno A. Harjoto & Hoje Jo, *Legal vs. Normative CSR: Differential Impact on Analyst Dispersion, Stock Return Volatility, Cost of Capital, and Firm Value*, 128 J. BUS. ETH. 1 (2015); Cecily Raiborn, Dinah Payne, & Brenda Joyner, *Environmentally Friendly Business Strategies: BP—A Case of Rhetoric or Reality?* 19 J. BUS. & MGMT. 67 (2013).

<sup>59</sup> Ante Glavas & Jenny Mish, *Resources and Capabilities of Triple Bottom Line Firms: Going over Old or Breaking New Ground?* 127 J. BUS. ETH. 623 (2015).

<sup>60</sup> Jan Tullberg, *Triple Bottom Line—a Vaulting Ambition?* 21 BUS. ETH. EURO. REV. 310 (2012).

<sup>61</sup> Denise Baden & Ian A. Harwood, *Terminology Matters: A Critical Exploration of Corporate Social Responsibility Terms*. 116 J. BUS. ETH. 615 (2013).

<sup>62</sup> Wettstein, *supra* note 15.

<sup>63</sup> McPhail, *supra* note 11.

<sup>64</sup> Mena & Palazzo, *supra* note 22.

<sup>65</sup> Adefolake Adeyeye, *Role of Global Governance in CSR*, 9 SANTA CLARA J. INTL. L. 149 (2011); Denis G. Arnold, *Transnational Corporations and the Duty to Respect Basic Human Rights*, 20 BUS. ETH. QUART. 371 (2010).

Thankfully, the growth of human rights principles and CSR is not relegated to mere rhetoric. Empirical data substantiates the reality that competitive advantage stems from higher corporate respect for sustainability standards.<sup>66</sup> For example, notorious violators Nike and Shell have tackled human rights issues related to physical coercion, forced labor, and forced migration, as well as embraced environmental protection goals.<sup>67</sup> Similarly, the emergence of fair-trade and “green” products reflects sensitivity to social issues within the business community.<sup>68</sup> Top pharmaceutical companies are working alongside the World Health Organization (WHO) and other non-governmental organizations to provide improved access to medical care in emerging nations. For example, GlaxoSmithKline disseminated voluntary licenses for prescription drugs to treat respiratory illnesses, mumps, and the measles.<sup>69</sup> Similarly, Johnson and Johnson voluntarily removed dangerous preservatives from its products.<sup>70</sup> Finally, the apartheid regime in South Africa resulted in the withdrawal of local foreign direct investment by numerous MNCs.<sup>71</sup> The actions of MNCs support the progress of social, environmental, and human rights.<sup>72</sup> Yet despite these efforts, a gap between policy and implementation remains. Only 28% of the top 25 Fortune 500 companies for 2014 had a human rights record that satisfied more than three of the five levels of CSR compliance.<sup>73</sup> Consequently, organizations may encounter difficulties when attempting to legally operationalize sustainability and human rights measures.<sup>74</sup>

### **Reexamining the Dichotomy: Managing Socially Conscious Corporate Leadership**

Corporations face growing demands to disclose the environmental and social impact of their international operations.<sup>75</sup> Many Americans feel that it is imperative for industry to champion social causes.<sup>76</sup> As a business entity, critics have characterized the corporation as a

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<sup>66</sup> Daniel Hollos, Constantin Blome, & Kai Foerstl, *Does Sustainable Supplier Co-operation Affect Performance? Examining Implications for the Triple Bottom Line*, 50 INTL J. PROD. RSCH. 2968 (2012); Uzoechi Nwagbara & Patrick Reid, *Corporate Social Responsibility (CSR) and Management Trends: Changing Times and Changing Strategies*, 65 ECON. INSIGHTS-TRENDS & CHALLENGES 12 (2013).

<sup>67</sup> Denis G. Arnold & Andres Valentin, *Corporate Social Responsibility at the Base of the Pyramid*, 66 J. BUS. RSCH. 1904 (2013).

<sup>68</sup> Kimberly K. Merriman & Sagnika Sen, *Incenting Managers toward the Triple Bottom Line: An Agency and Social Norm Perspective*, 51 HUM. RES. MGMT. 851 (2012).

<sup>69</sup> Access to Medicine Foundation, *Access to Medicine Index 2014*, [http://www.accesstomedicineindex.org/sites/2015.atmindex.org/files/2014\\_accessstomedicineindex\\_fullreport\\_clickablepdf.pdf](http://www.accesstomedicineindex.org/sites/2015.atmindex.org/files/2014_accessstomedicineindex_fullreport_clickablepdf.pdf) (last visited December 8, 2015).

<sup>70</sup> Harjoto & Jo, *supra* note 58.

<sup>71</sup> Tom Campbell, *A Human Rights Approach to Developing Voluntary Codes of Conduct for Multinational Corporations*, 16 BUS. ETH. QUART. 255 (2006).

<sup>72</sup> Arnold, *supra* note 65; Arnold & Valentin, *supra* note 67; William Bradford, *Beyond Good and Evil: The Commensurability of Corporate Profits and Human Rights*, 26 NOTRE DAME J. L. ETH. & PUB. POL. 141 (2012).

<sup>73</sup> Evan Peterson, Joni Hyska, & Dhruv Patel, *Human Rights Law, Corporate Governance, and Globalization*, 23 J. L. BUS. & ETH (forthcoming); David Scheffer & Caroline Kaeb, *The Five Levels of CSR Compliance: The Resiliency of Corporate Liability under the Alien Tort Statute and the Case for a Counterattack Strategy in Compliance Theory*, 29 BERKELEY J. INT'L L. 334 (2011).

<sup>74</sup> Thomas Macagno, *A Model for Managing Corporate Sustainability*, 118 BUS. & SOC. REV. 223 (2013).

<sup>75</sup> Bozena Guziana & Peter Dobers, *How Sustainability Leaders Communicate Corporate Activities of Sustainable Development*, 20 CORP. SOC. RESP. & ENVIRN. MGMT 193 (2013).

<sup>76</sup> Joseph K. Grant, *When Making Money and Making a Sustainable and Societal Difference Collide: Will Benefit Corporations Succeed or Fail?* 46 IND. L. REV. 581 (2013) (automotive and transportation industry 81%, food and beverage industry 82%, footwear and apparel industry 77%, health and beauty industry 78%, household goods

broken piece of social technology with legal personality but no interest in humanity.<sup>77</sup> To a certain degree, the fault is placed upon the entity type itself, leading scholars to assert that corporations now jeopardize the survival of humanity.<sup>78</sup> Traditional principles regarding corporate purpose, which originated from the position that the sole purpose of a corporation is to maximize shareholder wealth,<sup>79</sup> provided little support for social entrepreneurs wishing to cultivate enterprises with a sincere commitment to positive social and environmental progress. For example, the results of a 2007 poll indicated that over 70% of social entrepreneurs regarded the challenges associated with entity types as paramount to their respective enterprises.<sup>80</sup> Directors and executives who supported stakeholder interests at the expense of shareholder rights risked possible shareholder derivative suits and other legal penalties.<sup>81</sup> Such principles originated from the outlook that corporations have one purpose: generate and maximize shareholder wealth. Also referred to as the shareholder approach to corporate governance, legal compliance is the solitary controlling principle of ethical corporate behavior. Due to the deep-rooted nature of the shareholder perspective within the United States legal system, genuine concern for social and human rights cannot become a systematic fundamental corporate practice without legislative change.<sup>82</sup> The growth of such change, however, remains hindered by the ongoing debate regarding whether organizations may consider the interests of non-shareholder stakeholder groups.<sup>83</sup>

In response to growing public demands, organizational challenges, and policy objectives, alternatives to the traditional corporate entity type have emerged in recent years.<sup>84</sup> Specifically,

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industry 77%, manufacturing industry 81%, retail industry 79%, sports and entertainment industry 80%, and telecommunications industry 78%).

<sup>77</sup> L. Metcalf & S. Benn, *The Corporation is Ailing Social Technology: Creating a 'Fit for Purpose' Design for Sustainability*, 111 J. BUS. ETH. 195 (2012); Benjamin K. Sovacool, *Broken by Design: The Corporation as a Failed Technology*, 15 SCI. TECH. & SOC. 1 (2010).

<sup>78</sup> *Id.*

<sup>79</sup> See, e.g., Regina Robson, *A New Look at Benefit Corporations: Game Theory and Game Changer*, 52 AM. BUS. L. J. 501 (2015); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and the Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006); Thomas M. Jones & Will Felps, *Shareholder Wealth Maximization and Social Welfare: A Utilitarian Critique*, 23 BUS. ETH. QURT. 207 (2013); Leo E. Strine Jr., *Can we do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, COL. L. REV. 449 (2014); Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389 (2014).

<sup>80</sup> Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective* (2007), <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf>

<sup>81</sup> Matthew J. Dulac, *Sustaining the Sustainable Corporation: Benefit Corporations and the Viability of Going Public*, 104 GEO. L. J. 171 (2015); Grant, *supra* note 76.

<sup>82</sup> Mia M. Rahim & Shawkat Alam, *Convergence of Corporate Social Responsibility and Corporate Governance in Weak Economies: The Case of Bangladesh*, 121 J. BUS. ETH. 607 (2014); Suzanne Young & Vijaya Thyil, *Corporate Social Responsibility and Corporate Governance: Role of Context in International Settings*, 122 J. BUS. ETH. 1 (2014).

<sup>83</sup> See Robson, *supra* note 4 at 501; See also J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and the Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012).

<sup>84</sup> Brett H. McDonnell, *Committing to Doing Good and Doing Well: Fiduciary Duty in Benefit Corporations*, 20 FORDHAM J. CORP. & FIN. L. 19 (2014-2015); Even shareholders--the putative beneficiaries of the wealth maximization norm--have pressured companies to recognize larger corporate responsibilities. Emily Chasan, *Social Causes Come Calling*, WALL ST. J., Apr. 1, 2014, at B-8 (noting that year to date fifty-six percent of shareholder proposals related to environmental or social issues--an increase of approximately forty percent from the two previous years). The result has been a growing interest in trying to blend societal welfare and financial objectives.

investors and social entrepreneurs have displayed a growing interest in creating businesses with dual goals: (a) pursuit of profits for investors; and (b) pursuit of social goals. Businesses with such a twofold purpose are referred to as social enterprises.<sup>85</sup> Although such hybrid organizations have existed for years in the microcredit and healthcare sectors, the recent expansion has encompassed organizations in the consulting, information technology, environmental services, and retail sectors.<sup>86</sup> The core of the hybridization movement lies in the convergence between the social and commercial spheres.<sup>87</sup> According to the U.S. Social Investment Forum, socially responsible and sustainable investing grew by more than 10% between 2007 and 2010.<sup>88</sup> Similarly, estimates by J.P. Morgan suggested that the ten-year profit potential derived from socially responsible and sustainable investment may surpass \$650 billion.<sup>89</sup> As a result of the magnitude of this growth, scholars have designated social entrepreneurship as the fourth economic sector in the United States alongside business, government, and non-profit undertakings.<sup>90</sup> The entities comprising the social enterprise landscape in the United States fall into four major categories: social purpose corporations (SPCs), low-profit limited liability companies (L3Cs), flexible purposes corporations (FPCs), and benefit corporations (BCs). In light of the disparity in legislative activity across these four categories, however,<sup>91</sup> the discussion in the following sections will focus solely on benefit corporations.

### Benefit Corporations

Given the gaps and resulting challenges to social enterprise, it is unsurprising that in recent years several states have enacted a new form of business entity: the benefit corporation. The creation and oversight of benefit corporations are accomplished using incorporation statutes and legal rules that are largely similar to those utilized by traditional for-profit corporations.<sup>92</sup> The chief characteristics of benefits corporation statutes encompass five requirements: (a) the purpose of the benefit corporation must be to provide a public benefit<sup>93</sup>; (b) realization of the

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See HEERAD SABETI, *THE EMERGING FOURTH SECTOR* 1, 5, <http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/4th%20sector%20paper%-%20exec%20summary%20FINAL.pdf> (defining “for-benefit” entities as “organizations that *pursue social purposes while engaging in business activities*”).

<sup>85</sup> Hans Rawhouser, Michael E. Cummings, & Andrew Crane, *Benefit Corporation Legislation and the Emergence of a Social Hybrid Category*, 57 CALIF. MGMT REV. 13 (2015).

<sup>86</sup> Julie Battiliana, Matthew Lee, John Walker, & Cheryl Dorsey. *In Search of the Hybrid Ideal*. 10 STAN. SOC. INNOV. REV. 50, 50 (2012).

<sup>87</sup> *Id.*

<sup>88</sup> Soc. Inv. Forum, *Report on Socially Responsible Investing Trends in the United States* 8 (2010), <http://ussif.org/resources/research/documents/2010TrendsES.pdf> (last visited December 8, 2015).

<sup>89</sup> J.P. Morgan, *Impact investments: An Emerging Asset Class* (November 29, 2010), [https://www.jpmorgan.com/corporate/socialfinance/document/impact\\_investments\\_nov2010.pdf](https://www.jpmorgan.com/corporate/socialfinance/document/impact_investments_nov2010.pdf)

<sup>90</sup> J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 UNIV. MIAMI L. REV. 1 (2011).

<sup>91</sup> Only four states (Washington, California, Texas, and Florida) have active SPC legislation. Similarly, only 9 states (Utah, Wyoming, Louisiana, Illinois, Michigan, Vermont, Maine, and Rhode Island) have active L3Cs legislation. In contrast, over 30 states have active benefit corporation legislation.

<sup>92</sup> McDonnell, *supra* note 84; Robert J. Shiller, *Capitalism and Financial Innovation*, 69 FIN. ANALYSTS J. 21 (2013); Dana B. Reiser, *Benefit Corporations-A Sustainable Form of Organization*, 46 WAKE FOR. L. REV. 591 (2011).

<sup>93</sup> Examples of a public benefit include: (a) delivering beneficial services and products to low-income or individuals and communities; (b) endorsing economic opportunities beyond mere job creation in the ordinary course of

public benefit must be reviewed annually using an independent, third-party standard; (c) directors have a duty to consider a larger array of interests beyond the maximization of shareholder profit; (d) transparency; and (e) enforcement via a benefit enforcement proceeding.<sup>94</sup> In short, a benefit corporation is a for-profit legal entity that possesses societal responsibilities alongside all the traditional characteristics of a corporation.<sup>95</sup>

The rise of the benefit corporation is a reaction to common scenario reflected in the Ben & Jerry dilemma.<sup>96</sup> The dilemma refers to the case where the proprietors of Ben & Jerry’s ice cream felt obligated to sell the business to the top bidder, thereby sacrificing their environmental and social standards. Legal counsel had advised the owners that failure to sell to the top bidder would invite the possible of shareholder litigation.

### The Debate

Proponents of the benefit corporation assert that the social hybrid form will have a constructive influence on numerous societal groups, including entrepreneurs, consumers, and employees.<sup>97</sup> In contrast, opponents of the benefit corporation claim that the new organization type will lead to difficulties for lawmakers, regulators, and existing organizations.<sup>98</sup> Four dimensions encompass the debate surrounding the creation of a new hybrid category of business entities (see Figure 1):<sup>99</sup>

Dimension	Supporting Arguments	Conflicting Arguments
Impact	Societal Spillovers: raise bar for social impact; economic stimulus	Category Threat: siphons resources; decreased legitimacy
Legal	Organizational Flexibility: organization less restricted in combination of activities	Regulatory Enforcement: difficult to determine boundary; who enforces and how?
Demand	Cultural Shift: Existing organizational categories out of alignment w/current needs; new category better addresses emerging needs	Category Redundancy: Existing categories are sufficient to address current and new needs
Identity	Stakeholder Clarity: prevents mission drift; mission more apparent to stakeholders	Stakeholder Confusion: novelty impedes stakeholder ability to determine organizational relationship to existing categories

Figure 1. Arguments Supporting and Opposing Benefit Corporation Legislation

As indicated above, opponents have attacked the benefit corporation concept on a variety of levels. For example, critics assert that the structure of the benefit corporation may adversely impact shareholders’ rights, the organization’s ability to meet its mission, the accountability of

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business; (c) environmental preservation; (d) improvements to human health; (e) encouraging the sciences, arts, and advancement of knowledge; (f) providing financial support to public benefit entities; and (g) achieving other benefits the environment or society.

<sup>94</sup> Janine S. Hiller, *The Benefit Corporation and Corporate Social Responsibility*, 118 J. BUS. ETH. 287 (2013).

<sup>95</sup> Dulac, *supra* note 81; Grant, *supra* note 76; Hiller, *supra* note 94.

<sup>96</sup> Rae André, *Assessing the Accountability of the Benefit Corporation: Will this New Gray Sector Organization Enhance Corporate Social Responsibility?* 110 J. BUS. ETH. 133 (2012).

<sup>97</sup> *Id.* See also Robson, *supra* note 4.

<sup>98</sup> See André, *supra* note 96.

<sup>99</sup> *Id.*

officers and directors, and investors' willingness to provide fresh capital.<sup>100</sup> Others have claimed that social hybrid legislation could destabilize current for-profit and non-profit organizations.<sup>101</sup> Benefit corporations lack effective accountability measures. In addition, critics have raised the argument a novel category of business that integrates financial and social goals will lead to greater shareholder confusion.<sup>102</sup> Specifically, the election of benefit corporation status inserts a measure of ambiguity and potential loss of shareholder control as compared to the traditional corporate structure.<sup>103</sup> Moreover, some legislators assert that due to widespread corporate support for social issues, there is no need to create state-sanctioned social enterprises.<sup>104</sup> The aspirations to preserve the status quo underlying such criticisms further support the need for a fundamental redesign of the corporate entity to realize a holistic fit with society and the environment.<sup>105</sup>

### The Path Forward

In many corporations across the globe, business success is measured by examining the bottom line. The customary economic model prizes quantity consumption over quality consumption.<sup>106</sup> Accordingly, organizations frequently have a humble grasp of the methods necessary to operationalize sustainability processes in a legal manner.<sup>107</sup> Global sustainability measures cannot succeed absent support from the business community.<sup>108</sup> To address the developing challenges confronting social and ecological sustainability measures, it is necessary for socially conscious leaders to welcome innovative business paradigms.<sup>109</sup> The benefit corporation signifies such a revolution. Market leaders retain the standing and the assets necessary to support the creation of ethical market agendas.<sup>110</sup> More importantly, leaders possess the ability to articulate a unifying vision and address the challenges that hinder the execution of sustainability initiatives.<sup>111</sup> By pursuing socially conscious corporate strategies that are sanctioned from a corporate law standpoint, firms may promote global social responsibility and sustainability while generating profits in the process.<sup>112</sup> As noted in Appendix A, there is a continuum of enactment with respect to benefit corporation legislation across the United States: 30 states in the U.S. have active benefit corporation legislation, 6 states have proposed benefit corporation legislation, 8 states attempted but failed to enact benefit corporation legislation, and 6 states have no benefit corporation activity.

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<sup>100</sup> Justin Blount & Kwabena Offei-Danso, *Benefit Corporation: A Questionable Solution to a Non-Existent Problem*, 44 ST. MARY'S L.J. 617 (2012-2013).

<sup>101</sup> Rawhouser, Cummings, & Crane, *supra* note 85.

<sup>102</sup> *Id.*

<sup>103</sup> Blount & Offei-Danso, *supra* note 100.

<sup>104</sup> Rawhouser, Cummings, & Crane, *supra* note 85.

<sup>105</sup> Metcalf & Benn, *supra* note 77.

<sup>106</sup> Martinez-Alier et al., *supra* note 26.

<sup>107</sup> Macagno, *supra* note 74.

<sup>108</sup> Don Mayer, *Legal Loopholes, Business Ethics, and Corporate Legal Strategy: A Reply to Professor Ostas*, 46 AM. BUS. L. J. 713 (2011).

<sup>109</sup> Michael Shellenberger & Ted Nordhaus, *The Death of Environmentalism*. 35 SOC. POL. 19 (2005).

<sup>110</sup> Nicola M. Pless, Thomas Maak, & Gunter K. Stahl, *Developing Responsible Global Leaders through International Service-Learning Programs: The Ulysses Experience*. 10 ACAD. MGMT. LRN. & EDUC. 237 (2011).

<sup>111</sup> Roxana M. Pivodă, *Challenges and Risks to Manage Sustainability throughout the Value Chain*, 4 ECON. MGMT. & FIN. MKTS. 296 (2014).

<sup>112</sup> See Peterson et al., *supra* note 42.

The emergence of social enterprise legislation in the United States is a relatively recent trend. Maryland was the first state to enact benefit corporation legislation in 2010. By 2015, over 30 states had enacted such legislation. Over 88% of states have enacted or attempted to enact such legislation. Only six states (Georgia, Mississippi, Ohio, South Dakota, Washington, and Wyoming) have failed to undertake any benefit corporation activity. What is the explanation for such marked growth? Has consumer disdain for corporate malfeasance finally reached a breaking point? Another possible explanation centers on the changing demographics of the global workforce. According to a 2015 survey,<sup>113</sup> 75% of Millennials believe that modern corporations have failed to display adequate support and concern for efforts to improve global society. In addition, the survey results also highlighted Millennials' belief that the pursuit of profit must be complemented by the consideration and facilitation of societal interests.

Predictably, social enterprise efforts are not confined to the United States. For example, countries in the G8 have created legal and regulatory systems in support of social enterprise.<sup>114</sup> The Group of Eight (G8) denotes the collection of eight industrialized nations (United States, Canada, United Kingdom, France, Germany, Italy, Japan, and Russia) that participate in an annual conference to promote consensus and cooperation on global issues, such as terrorism, global security, economic growth, and energy.<sup>115</sup> Similar to the benefit corporation status designation in the United States, companies that pursue profit-generating activities while working to achieve social purpose are denoted as profit-with-purpose businesses or PPBs. PPBs have three defining characteristics: (a) expressly espouse a mission to advance the common good; (b) duties of those making management decisions for a PPB should include a duty to further the social purpose of the business; and (c) PPB should evaluate and report on its success in achieving its social purpose using a standard means of measurement.<sup>116</sup> This could take the form of an impact assessment standard promulgated and/or verified by an independent third party. The result of this research is noted the figure below:

<b>Country</b>	<b>Legal Form Created Specifically for PPB</b>	<b>PPB Using Traditional Legal Structures</b>
United States	<ul style="list-style-type: none"> <li>• Benefit Corporation (“BC”)</li> <li>• Low-Profit Limited Liability Company (“L3C”)</li> <li>• Flexible Purpose Corporation (“FPC”)</li> <li>• Social Purpose Corporation (“SPC”)</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
Canada	<ul style="list-style-type: none"> <li>• Community Contribution Company (“C3”) – British Columbia</li> <li>• Community Interest Company (“CIC”) – Nova Scotia</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>

<sup>113</sup> *Mind the gaps. The 2015 Deloitte millennial survey*, DELOITTE, <http://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-wef-2015-millennial-survey-executivesummary.pdf> (last visited December 8, 2015) (Study participants included over 7,800 individuals from 29 countries. Participants were employed full-time, possessed a college or university degree, and worked primarily in private-sector organizations of 100 employees or more.

<sup>114</sup> See Orrick, Herrington & Sutcliffe LLP, *supra* note 3.

<sup>115</sup> Zachary Laub, *The group of eight (G8) industrialized nations* (March 3, 2014), <http://www.cfr.org/international-organizations-and-alliances/group-eight-g8-industrialized-nations/p10647>

<sup>116</sup> Orrick, Herrington & Sutcliffe LLP, *supra* note 3.

United Kingdom	<ul style="list-style-type: none"> <li>• Community interest company (“CIC”)</li> <li>• Community benefit society (“CBS”)</li> <li>• Private company limited by guarantee (“CLG”)</li> <li>• Private company limited by shares (“CLS”)</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
France	<ul style="list-style-type: none"> <li>• Country currently has no legal form created specifically for PPBs.</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
Germany	<ul style="list-style-type: none"> <li>• Country currently has no legal form created specifically for PPBs.</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
Italy	<ul style="list-style-type: none"> <li>• Country currently has no legal form created specifically for PPBs.</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
Japan	<ul style="list-style-type: none"> <li>• Country currently has no legal form created specifically for PPBs.</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>
Russia	<ul style="list-style-type: none"> <li>• Country currently has no legal form created specifically for PPBs.</li> </ul>	<ul style="list-style-type: none"> <li>• Social entrepreneurs can integrate social purpose into generally available “commercial” entity forms</li> </ul>

Figure 2. Overview of Profit with Purpose Business Models across G8 Countries.

Although the efforts from the G8 countries serve as a source of encouragement for the further spread of social enterprise legislation on a global scale, international treaties cannot render such legislation binding on corporate actors. Despite the voluntary nature of social enterprise legislation, however, the rise of benefit corporations and other social enterprises have the potential to driver transformational change and lead the way for a new paradigm in business behavior.<sup>117</sup> In light of cultural differences throughout the globe, however, a fundamental question remains: Is it truly possible to foster a worldwide business environment where social enterprise reflects a common business practice rather than a notable exception to the rule of profits before people and planet?

By reexamining the mutable role of global leadership, there is evidence to suggest that the answer yes. The GLOBE project researchers examined the cultural practices from ten cultural clusters throughout the world. The results of the massive research initiative uncovered data to support the presence of universally desirable leadership attributes that spread across all GLOBE countries, including the ability to inspire confidence, trustworthiness, honesty, dependability, and intelligence.<sup>118</sup> Additionally, the researchers identified universal cross cultural support for

<sup>117</sup> See Robson, *supra* note 4 at 501.

<sup>118</sup> Mansour Javidan, Peter M., Dorfman, Mary S. De Luque, & Robert J. House, *In the Eye of the Beholder: Cross-Cultural Lessons in Leadership from Project Globe*. 20 ACAD. MGMT. PRSPCT. 67 (2006) (Countries include Anglo, Germanic Europe, Middle East, Southern Asia, Eastern Europe, Latin America, Nordic Europe, Latin Europe,

altruism, encouragement, character and integrity, and collective motivation.<sup>119</sup> Coincidentally, these four universal attributes share commonalities with the six characteristics of ethical leadership: (a) ethical awareness; (b) character and integrity; (c) community and people orientation; (d) managing ethical accountability; (e) motivation; and (f) encouragement and empowerment.<sup>120</sup> If responsible leadership is defined as a value driven relationship between stakeholders and leaders focused on shared purpose, meaning, and commitment to social change,<sup>121</sup> these shared aims represent a potential basis through which consumers, ethicists, and entrepreneurs alike may push for the further social enterprise legislation across the globe.

### Conclusion

The traditional viewpoint that businesses only lead to social problems has a wealth of support in the academic literature. The negative externalities associated with shareholder profit maximization are facilitated by corporate lobbying efforts and ineffective governmental regulation. However, there is growing support to the claim that businesses can solve social problems by utilizing their tremendous resources and influence to generate profits by meeting important needs. The benefit corporation represents a potential framework for balancing the inherent tension between the corporate quest for profit and corporate social responsibility. Unfortunately, only a few states have enacted legislation to support the benefit corporation as a business entity. As a result, a variety of opportunities for future research exists concerning the nature of existing legislative deficiencies as well as the measures necessary to grow public support for the new form of social enterprise.

### APPENDIX A<sup>122</sup>

#### Overview of Benefit Corporation Legislation in the United States

States with Active Benefit Corporate Legislation	States with Proposed Benefit Corporation Legislation
Arizona Ariz. Rev. Stat. §§ 10-2401 to-2422 (2014)	Alaska H.B. 49, 29th Legis., (Alaska. 2015)
Arkansas Ark. Code Ann. §§ 4-36-101 to- 4-36-401 (2013)	Iowa S.S.B. 1188, 86th Gen. Assemb. (Iowa 2015)
California Cal. Corp. Code §§ 14600 - 14631 (2013)	Kentucky B.R. 225, 2016 Reg. Sess. (Ky. 2016)
Colorado Col. Rev. Stat. §§ 7-101-501 to -511, 6-113-102 (2013)	North Carolina H.B. 534, 2014-2015 Sess. (N.C. 2015)
Connecticut S.B. 23, 2014 Sess. (Ct. 2014)	Oklahoma H.B. 1039, 55th Legis., 1st Sess. (Ok. 2015)
Delaware	Wisconsin

Confucian Asia, and Sub-Saharan Africa); Anne H. Reilly & Tony J. Karounos, *Exploring the Link between Emotional Intelligence and Cross-Cultural Leadership Effectiveness*, 1 J. INT'L. BUS. & CULT. STUD. 1 (2009).

<sup>119</sup> Christian J. Resick, Paul J. Hanges, Marcus W. Dickson, & Jacqueline K. Mitchelson, *A Cross-Cultural Examination of the Endorsement of Ethical Leadership*. 63 J. BUS. ETH. 345 (2006).

<sup>120</sup> *Id.*

<sup>121</sup> Thomas Maak & Nicola M. Pless, *Business Leaders as Citizens of the World. Advancing Humanism on a Global Scale*, 88 J. BUS. ETH. 537 (2009).

<sup>122</sup> Adapted from Social Enterprise Law Tracker, <http://www.socentlawtracker.org/#/bcorps> (last visited December 8, 2015).

Del. Code Ann. tit. 8, §§ 361-368 (2013)	A.B. 59, 2015-2016 Leg. Sess. (Wisc. 2015)
Florida Fla. Stat. Ann. §§ 607.601 to-.613 (2014)	
Hawaii Haw. Rev. Stat. §§ 420D-1 to -13 (2013)	<b>States with Failed Benefit Corporation Legislation</b>
Idaho Idaho Code Ann. §§ 30-20-01 to- 30-20-13 (2015)	Alabama S.B. 14, 2014 Reg. Sess. (Ala. 2013)
Illinois 805 Ill. Comp. Stat. Ann. 40/1 to- 40/5.01 (2013)	Kansas H.B. 2650, 2013-2014 Leg. Sess. (Kan. 2014)
Indiana H.B. 1015, 119th Gen. Assemb., 2015 Sess. (Ind. 2015)	New Mexico S.B. 96, 52nd Leg., 1st Sess. (N.M. 2015)
Louisiana La. Rev. Stat. Ann. §§ 12:1801 to- 1832 (2012)	North Dakota H.B. 1237, 64th Legis. Assemb., (N.D. 2015)
Maryland Md. Code Ann., Corps. & Ass'ns §§ 5-6C-01 to- 5-6C-08 (2013)	Maine L.D. 1154/H.P. 792, 127th Legis., 1st Reg. Sess (Me. 2015)
Massachusetts Mass. Gen. Laws Ch. 156E, §§ 1-16 (2013)	Michigan H.B. 4526/27, 98th Leg. Reg. Sess. (Mich. 2013)
Minnesota Minn. Stat. Ann. §§ 304A.001 to- 304A.301 (2015)	Missouri H.B. 1956, 97th Gen. Assemb., 2d Reg. Sess. (Mo. 2014)
Montana H.B. 258, 64th Leg. Sess. (Mont. 2015)	Texas H.B. 2565, 83rd Leg. (Tx. 2013)
Nebraska Neb. Rev. Stat. §§ 21-401 to- 414 (2014)	
Nevada Nev. Rev. Stat. §§ 78B.010 to- .190 (2014)	<b>States with No Benefit Corporation Activity</b>
New Hampshire N.H. Rev. Stat. Ann. §§ 293-C:1 to- 13 (2014)	Georgia
New Jersey N.J. Stat. Ann. §§ 14A:18-1 to- 11 (2013)	Mississippi
New York N.Y. Bus. Corp. Law §§ 1701-1709 (2013)	Ohio
Oregon Ore. Rev. Stat. §§ 60.750 to- .770 (2014)	South Dakota
Pennsylvania 15 Penn. Cons. Stat. §§ 3301-3305 (2013)	Washington
Rhode Island R.I. Gen. Laws Ann. §§ 7-5.3-1 to- 7-5.3-13 (2013)	Wyoming
South Carolina S.C. Code Ann. §§ 33-38-110 to -600 (2013)	
Tennessee Tenn. Code Ann. §§ 48-28-101 to- 48-28-402 (Tenn. 2015)	
Utah Utah Code §§ 16-10b-101 to 16-10b-402 (2014)	
Vermont Vt. Stat. Ann. tit. 11A §§ 21.01 to -.14 (2013)	
Virginia Va. Code Ann. §§ 13.1-782 to -791 (2013)	
West Virginia W. Va. Code Ann. §§ 31F-1-101 to -501 (2014)	



## THE RELATIONSHIP BETWEEN THE PROTESTANT WORK ETHIC, EMPATHY AND BUSINESS STUDENTS' DISTRUST OF CORPORATIONS

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### ABSTRACT

*The Great Recession of 2008-2012 and the ensuing corporate scandals (e.g. Lehman Brothers) had a negative effect on corporate ethical perception. This study examines the extent of business students' distrust of corporations during the Great Recession. To better understand the correlates of such distrust, psychological factors such as Protestant Work Ethic and Empathy are examined. The results showed that business students had generally slight distrust of corporations during this period. Students with high work ethic had lower distrust of corporations compared to students with low work ethic. However, students showing higher levels of empathy for others showed higher distrust of corporations compared to students with less empathy. Significant demographic factors also emerged that have implications for business education and employers.*

The Great Recession of 2008-2012 has been described as the worst economic downturn in the U.S. since the Great Depression (Highhouse et al. 2014). This recession was unique in its speed of capital markets collapse and the rapid pace of bankruptcies that followed (Yandle, 2010). This financial meltdown caused a severe lack of trust in corporations in general who were reeling from an earlier wave of high-profile bankruptcies such as Enron and WorldCom (Yandle, 2010).

The purpose of this study is to examine the extent of corporate distrust during the Great Recession. The study uses undergraduate business students for several reasons: First, they have paid close attention to the negative media publicity of corporate failures during this period of time. Second, they have studied several case studies of such failures in details. Finally, they represent the population of future corporate employees. The study also examines some psychological factors that may affect corporate distrust. Specifically, the study examines work ethic (as operationalized by the Protestant Work Ethic (PWE)) and Empathy as potential determinants of distrust. The study's results have implications for business instructors and for corporate managers as they tried to recruit the best talent available during a period of difficult economic circumstances.

The paper is organized as follows: The following section presents a literature review of corporate distrust and its antecedents, followed by a background of the study's psychological variables: Work Ethic and Empathy. The study's research design is explained followed by the sample characteristics and the measurements. Finally, the study's results are presented along with possible academic and practical implications.

## LITERATURE REVIEW AND HYPOTHESES

### *Corporate Distrust*

The last decade has witnessed the collapse of many corporations (e.g. AIG and Lehman Brothers). Yandle (2010) attributed these failures to the loss of trust in corporations and the financial system at that time due to Wall Street executives' opportunistic behavior.

Research on trust in corporations has been extensive and multidimensional. Rotter (1967, 653) defined trust as "an expectancy held by an individual or a group that the word, promise, verbal, or written statement of another individual or group can be relied upon." Trust is essential to virtually all market transactions (Yandle, 2010). For example, employees trust their corporate employers to keep their job (Verschoor, 2004) and under ideal democratic conditions, trust in corporate performance and behavior is a precondition for the legitimate exercise of corporate power (Rayman-Bacchus (2006). Leonidas et al. (2013) found that firms behaving in an unethical manner can harm the feeling of security, reliability, and integrity that consumers have for them, which are basic prerequisites for building trust.

The recent past has witnessed an interest in studying the loss of trust in specific corporations due to widely publicized ethical failures such as bribery (e.g. Siemens) and cheap labor (e.g. Nike). Research showed that corporations now have to work hard to earn consumers' trust (Yoo and Pae, 2016). However, Grayson et al. (2008) showed that trust must be considered from both a firm level (narrow-scope trust) and a wider industry perspective (broad-scope trust). Following this logic, Adams et al. (2010) advocated for studying overall distrust of corporations. During the Great Recession, there was a general distrust of corporations and financial institutions. Hurley et al. (2014) found that trust in banks in general has declined significantly over time and that banking was one of the least-trusted industries. They attributed this attitude to the negative publicity of unethical behavior of specific banks during the Great Recession (e.g. Washington Mutual).

Strong (1996) noted that the public was exposed to a greater level of media exposure to negative corporate behavior. Highhouse et al. (2014) found that media communication of an executive's year-end bonus during the recession elicited different investors' reactions depending on how the story was discussed and depending on the type of explanation given for such a bonus. Fiske and Neuberg (1990) found that information about specific category members can influence perceptions of that category as a whole. Adams et al. (2010) developed a model of overall corporate distrust which, they argued, was influenced by media reports and individual psychological variables (e.g. cynicism, liberalism and human nature).

The current study investigates the extent of business students' general distrust of corporations during the Great Recession, a period characterized by intense negative media publicity of unethical corporate behavior. We hypothesize that this negative publicity will result in an overall distrust of corporations.

H1: Business students will have high levels of general distrust of corporations during the Great Recession.

Research has also found that demographic factors play an essential role in perception. In this study, we also investigate the demographic factors that might influence such general distrust of corporations such as gender, age, class grade and chosen major. Since Adams et al. (2010) found that some psychological factors, such as cynicism, were strongly related to corporate distrust, this study examines PWE and Empathy as potential psychological factors related to the general distrust of corporations.

### ***Protestant Work Ethic***

After introducing the concept of PWE, Max Weber argued for a causal relationship between PWE and the development of capitalism in Western societies (Weber, 1958). Here originated the idea of the Puritan theology of a “calling”: The idea that working for the purpose of profit is a moral good in itself (Weber, 1958). Although Weber originally developed PWE as a strictly Protestant religious orientation, late research operationalized PWE as a personality variable, unrelated to religious beliefs. For example, Furnham and Reilly (1991) argued that the notion of success through hard work was generic in nature and was found in cross-cultural research regardless of the Protestant belief. Ghorpade et al. (2006) defined PWE as a personality variable consisting of a desire for hard work and success and found it to exist in a diverse ethno-religious sample. Mirels and Garrett (1991) found PWE to be positively correlated to interest in occupations demanding a concrete, pragmatic approach to work.

Significant research has investigated the consequences of PWE. Students who scored high on PWE studied harder and achieved higher GPAs (Poulton and Ng, 1988). Furnham (1987) found that those who scored higher on PWE ranked responsibility higher in their values hierarchy. Eisenberger and Shank (1985) found that this work ethic was positively associated with the tendency to refrain from cheating. Elias (2015) confirmed these results by finding that business students high on PWE viewed questionable cheating actions as unethical compared to others. In the workplace, Jones et al. (2005) found that employees high on PWE viewed questionable organizational actions as more unethical compared to other employees. In a study regarding the love of money, Luna-Arocas and Tang (2004) found that University professors who were money-worshippers were more likely to score high on PWE. Van Hoorn and Maseland (2013) noted that unemployment was much more detrimental to employees with a high PWE.

Several studies have related PWE to conservative political beliefs. Jones (1997) found that individuals high on PWE subscribed to the belief that able-bodied individuals have no right of assistance from others. PWE has also originally been associated with negative attitudes toward disadvantaged groups such as low-income or homeless individuals (Montheith and Spicer, 2000). However, some recent research argued that PWE may not always promote negative intergroup attitudes and may even have an additional egalitarian meaning with the implication that all people are equal and can succeed (e.g. Levy et al. 2010). In a meta-analysis of PWE’s relation to intergroup attitudes, Rosenthal et al. (2011) found substantial support for the theory that hard work was a social equalizer. Drawing on the findings of Furnham (1990) that PWE beliefs were associated with positive feelings toward free enterprise and negative feelings toward the role of government and the welfare state, the current study theorizes that business students high on PWE will have less overall distrust of corporations. It is interesting to specifically examine this relationship during the Great Recession, a period characterized by negative publicity about corporations.

H2: Business students high on PWE will have less overall distrust of corporations, even during the Great Recession.

### ***Empathy***

Empathy is a psychological construct defined as “the capacity to understand others’ emotions and experiences” (Lindsey et al. 2015, 609). Backstrom and Bjorklund (2007) showed that people high in Empathy were less likely to express racial prejudice. Lindsey et al. (2015) found that individuals low in Empathy benefited the most from diversity training methods. Cialdini et al. (1997) argued that empathic concern was characterized by compassion, tenderness,

soft heartedness and sympathy, all characteristics necessary for building durable relations with others.

Empathy entails one person taking the standpoint of others (Florea et al. 2013). Some research investigated the positive effects of Empathy in the workplace. Higgins and Kram (2001) noted that Empathy was likely to encourage formation of developmental relationships, such as mentoring, assistance received from peers, subordinates and superiors. Empathy was also likely to contribute to the quality of life and work-life balance (Valcour et al. 2011).

Ewest (2015) argued that for an action to be prosocial, it must contain the value of Empathy. An empathic act ensures the welfare of others in everyday life by progressing toward one's own goals without violating the justified goals of others (Bierhoff, 2002). During the Great Recession, there have been many examples of corporations violating the goals of others with disastrous consequences such as loss of jobs and life savings (Pardue et al. 2013). The current study examines the relationship between Empathy and corporate distrust during a time of overall negative corporate behavior. Frank and Schvaneveldt (2016) found that during natural disasters, individuals scoring high on Empathy expressed great sympathy with disaster victims and actually increased their purchases of potentially contaminated products from such disaster areas. Drawing on these findings of Empathy toward victims of corporate malfeasance, the following hypothesis is tested:

H3: Business students scoring high on Empathy were more likely to have high general distrust of corporations during the Great Recession.

## STUDY DESIGN

### *Sample Selection*

The sample consisted of undergraduate business students in two academic institutions on the West Coast (one large public AACSB-accredited University, and one medium liberal arts College). A survey containing the study measures was administered to students in a variety of business classes during class time. Anonymity was guaranteed. The survey took about 15 minutes to complete. A variety of demographic questions were included such as age, gender, class grade and chosen major. The final useable sample consisted of 474 students (333 in the public University and 141 in the private College). A comparison of students in both institutions on each study measure was conducted and no statistically significant differences were found. Both samples were therefore combined in the study's analyses.

### *Study Measures*

Several measures were used to conduct the study. A copy of the survey instrument, including the scales, is included in the Appendix. In order to measure general distrust of corporations, the scale developed by Adams et al. (2010) was used. The authors developed a 13-item questionnaire that reflected expectations about fairness and trustworthiness of corporations during a certain time period, rather than a particular corporation. The respondents recorded their agreement/disagreement with each statement on a seven-point scale ranging from 1 (strongly disagree) to 7 (strongly agree). Higher scores indicate higher general distrust of corporations. Survey reliability was estimated at .95. In the current study, it showed reliability of .88. In the current study, factor analysis was conducted and two factors emerged with eigenvalues greater than 1 as follows: Accountability (the respondent distrusts that corporate executives are accountable for their actions) and Intention (the respondent distrusts the corporate executives' intention).

In order to measure PWE, the scale developed by Ghorpade et al. (2006) was used. Many studies have used the scale developed by Mirels and Garrett (1971). However, some research (e.g. McHoskey 1994) has criticized the single-dimension nature of this scale. Ghorpade et al. (2006) modified the original Mirels and Garrett scale and developed an 11-item scale that yielded two factors: Success (measuring the desire to succeed and the importance placed on success) and Hard Work (measuring the enthusiasm for hard work and its importance) as well as a total PWE score. Respondents recorded their answers on a scale of 1 (strongly disagree) to 7 (strongly agree). Higher scores indicated higher PWE. Ghorpade et al. (2006) also argued that the work ethic is not unique to Protestants. Factor loadings achieved in the current study were .72 for success and .69 for hard work.

In order to measure Empathy, the scale used by Liau et al. (2011) was used. In their study, the authors developed what they termed the “Personal Strength Inventory”, a group of psychological constructs necessary for a person’s well-being and development. An important factor in this inventory is Empathy. The authors defined Empathy as “the ability to understand another’s emotional state and feel with that person” (Liau et al., 2011, 22). The scale consisted of three items measured on a scale of 1 (strongly disagree) to 7 (strongly agree). Higher scores indicate higher levels of Empathy. The original study reported an internal consistency reliability of 0.7 and the current study found it to be 0.78.

**STUDY RESULTS**

The first set of tests involved calculating Means and Standard Deviations for all variables in the study. The results are reported in Table 1. The results indicated that business students had slightly above average distrust of corporations, with a Mean of 4.64 on a 7-point scale. Business students had higher distrust of corporate executives’ intentions compared to business students’ distrust of executives’ accountability. These results moderately support H1. Regarding PWE, business students exhibited moderate levels of PWE with a Mean of 5.05 on a 7-point scale. In addition, they showed a higher enthusiasm for hard work compared to a desire for success. Business students also showed high levels of Empathy averaging 5.96 on a 7-point scale.

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 INSERT TABLE 1 ABOUT HERE  
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The analyses of demographic variables revealed significant differences based on age, gender and chosen major. Generally, younger students had lower levels of corporate distrust compared to older students. Also, younger students had higher levels of PWE compared to older students. Regarding gender differences, males had a higher level of corporate distrust compared to females but female students had a higher level of Empathy compared to males. Regarding business students’ chosen majors, CIS majors had the highest levels of corporate distrust followed by Marketing majors while General Business majors had the lowest levels followed by Economics majors.

The next series of tests involved investigating the relationships between corporate distrust, PWE and Empathy. Correlation analysis was used and the results are reported in Table 2.

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 INSERT TABLE 2 ABOUT HERE  
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The results indicate a negative relationship between PWE and general distrust of corporations. Business students with higher levels of PWE were less likely to distrust corporate executives' accountability or intentions and less likely to distrust corporations in general. These results support H2. In addition, there was a positive relationship between Empathy and corporate distrust. Business students who scored higher in Empathy were more likely to distrust corporate executives' accountability, intentions and more likely to distrust corporations in general. These results also support H3. An interesting positive relationship also emerged between PWE and Empathy. Students scoring higher on PWE were more likely to also score higher on Empathy. This relationship warrants further investigation in a future study.

### **DISCUSSION AND IMPLICATIONS**

During a time of economic crisis, this paper provided many useful results about the perception of corporations, which were considered the major reason for the Great Recession. Business students had a slight distrust of corporations. Although the extent of such distrust was lower than expected (4.64 out of 7), especially during an intense media campaign against corporations, it can be interpreted in two ways: First, it is possible that business students did not generalize the failures of specific companies to a potential wrongdoing of all corporations. Second, it is possible that business students did not assign the blame of the Great Recession solely to corporations. Rather, they may have believed that greedy consumers were partly responsible for the housing crisis, for example. This position was advocated by Hurley et al. (2014) who argued that banks and consumers had interests that coincided rather than conflicted during the Great Recession, and therefore the housing crisis occurred. Older students had higher distrust of corporations compared to younger students. These results showed that past negative experiences can lead to a more current negative attitude toward corporations. Since older students recalled the collapsed of Enron and Worldcom a decade before the Great Recession but younger students did not witness these events as they unfolded, older students seemed more suspicious of corporations in general.

The study also revealed several interesting relationships. Students with higher PWE were less distrusting of corporations. These findings support the theory presented by Furnham (1990) of a conservative political philosophy espoused by individuals high in PWE, specifically supporting free enterprise and corporations. Even with a negative media campaign against corporations, students high in PWE still believed in corporate executives' accountability and positive intentions. This leads us to believe that students with high PWE believed that employees should work in their companies and not be concerned with executives' responsibilities. On the other hand, the results regarding Empathy supported the theory advocated by Frank and Schvaneveldt (2016) that individuals high in Empathy support the victims of wrongdoing especially during difficult economic conditions. Since the Great Recession was blamed on greedy corporate executives, students with high Empathy scores had higher distrust of corporate executives' accountability and intentions.

The study has implications for academia and the workplace. Regarding academia, it shows that intense studies of negative corporate behavior can lead to at least moderate levels of overall corporate distrust. Instructors should be aware that such negative focus on specific corporations in case studies can lead to an overall negative perception of corporations. This is an undesirable effect since most business students will in fact seek jobs with corporations, regardless of their major. Instructors should distinguish between the wrongdoing of specific companies and corporations in general. In the workplace, employers should be aware that employees with a higher PWE have less distrust of corporations. This may be a desirable

outcome for those corporations, but it can also lead to negative outcomes if such employees do not reflect on their supervisors' possible unethical behavior, for example. The ethical impact of the relationship between PWE and corporate distrust is not the subject of the current study but is an interesting avenue for future research.

The study's results should be interpreted in light of the following limitation: Although the study was conducted in two different types of academic institutions, they are both located in the same metropolitan area, which leads to the potential of students' political orientation possibly confounding the results, as suggested by Adams et al. (2010). The impact of such variable is also an interesting avenue for future research.

**TABLE 1**  
**DEMOGRAPHIC CHARACTERISTICS AND SIGNIFICANT DIFFERENCES (N=474)**

<i>Panel A:</i>		<u>Means (SD)</u>	
Accountability	4.41	(1.39)	
Intention	4.79	(1.25)	
Total Distrust	4.64	(1.23)	
Success	4.78	(.92)	
Hard Work	5.37	(.93)	
Total PWE	5.05	(.75)	
Empathy	5.96	(1.02)	
<i>Panel B: Age Differences</i>			
	<u>&lt; 25 years</u>	<u>25 and &gt;</u>	
Accountability	4.21***	4.89***	
Intention	4.59***	5.26***	
Total Distrust	4.45***	5.12***	
Hard Work	5.44***	5.19***	
Total PWE	5.09**	4.93**	
<i>Panel C: Gender Differences</i>			
	<u>Male</u>	<u>Female</u>	
Accountability			
Intention	4.95***	4.60***	
Total Distrust	4.77***	4.49***	
Empathy	5.81***	6.13***	
<i>Panel D: Chosen Major Differences</i>			
	<u>Acct.</u>	<u>Man.</u>	<u>Mark.</u>
	<u>Econ.</u>	<u>CIS</u>	<u>Fina.</u>
	<u>Gen.</u>	<u>Nonbus.</u>	
<u>Distrust of Corporations</u>			
Accountability	4.39	4.76	4.89
	4.03	5.02	4.40
	3.71	4.64***	
Intention	4.81	5.08	5.05
	4.40	5.28	5.05
	4.15	4.92***	
Total Distrust	4.65	4.96	4.99
	4.26	5.18	4.80
	3.98	4.81***	
<b>1 = strongly disagree; 7 = strongly agree</b>			
<b>*** p&lt;.01   ** p&lt;.05   * p&lt;.10</b>			

**TABLE 2**  
**CORRELATION ANALYSES AND SIGNIFICANT RELATIONSHIPS**

	Account Intention Distrust	Total Distrust	Success Work	Hard PWE	Total PWE	Empathy
Account	.79***	.91***	-.06*	-.09**	-.08**	.89**
Intention		.95***	-.07*	-.06*	-.06*	.10**
Distrust			-.07*	-.07*	-.07*	.10**
Success			.31***	.84***		
Hard Work				.77***	.14***	
Total PWE					.08**	
*** P<.01; ** P<.05; * P<.10						

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**APPENDIX  
STUDY SURVEY**

**Please record your agreement or disagreement with each of the following statements according to the following scale. There are no right or wrong answers. Do not spend too much time on any question and record your first impression.** (adapted from Adams et al. (2010), Liau et al. (2011), and Ghorpade et al. (2006)).

<i>Strongly</i>	<i>Moderately</i>	<i>Slightly</i>	<i>Neutral</i>	<i>Slightly</i>	<i>Moderately</i>	<i>Strongly</i>
<i>Disagree</i>	<i>Disagree</i>	<i>Disagree</i>	<i>4</i>	<i>Agree</i>	<i>Agree</i>	<i>Agree</i>
<i>1</i>	<i>2</i>	<i>3</i>		<i>5</i>	<i>6</i>	<i>7</i>

- \_\_\_\_\_ Corporations are not respectful of laws
- \_\_\_\_\_ Corporations do not accept accountability for their actions
- \_\_\_\_\_ People who run corporations will lie if doing so will increase company profits
- \_\_\_\_\_ Corporations do not care about acting ethically
- \_\_\_\_\_ Corporations will break laws if they can make more money from it
- \_\_\_\_\_ Corporations put their own interests above the public's interests
- \_\_\_\_\_ Corporations are driven by greed
- \_\_\_\_\_ Corporations care only about money
- \_\_\_\_\_ Corporations want power at any cost
- \_\_\_\_\_ Corporations *take* a lot more than they *give*
- \_\_\_\_\_ Corporations intentionally deceive the public
- \_\_\_\_\_ Corporations do not consider the needs of their employees when making business decisions
- \_\_\_\_\_ Corporations exploit their workers
- \_\_\_\_\_ When I see someone being treated unfairly, I feel sympathy for them
- \_\_\_\_\_ I feel sorry for people when they are having problems
- \_\_\_\_\_ It makes me sad when I see someone left out in a group
- \_\_\_\_\_ There are few satisfactions equal to the realization that one has done one's best at a job
- \_\_\_\_\_ The most difficult college courses usually turn out to be the most rewarding
- \_\_\_\_\_ Most people who don't succeed in life are just plain lazy
- \_\_\_\_\_ The self-made individual is likely to be more ethical than one who is born to wealth
- \_\_\_\_\_ Any person who is able and willing to work hard has a good chance of succeeding
- \_\_\_\_\_ People who fail at a job have usually not tried hard enough
- \_\_\_\_\_ Hard work offers little guarantee of success
- \_\_\_\_\_ The person who can approach an unpleasant task with enthusiasm is the person who gets ahead
- \_\_\_\_\_ If one works hard enough, one is likely to make a good life for oneself
- \_\_\_\_\_ A distaste of hard work usually reflects a weakness of character
- \_\_\_\_\_ Hard work is fulfilling in itself



## EMPLOYMENT CONTRACT OR MERE WORDS? – THE TRAPS WORKERS FACE

**BRAD REID\***

### **Abstract**

*If an employer lies about prospective employment or the duration and conditions of employment, what remedy does an employee have? What happens if there are unforeseen general economic or business specific changes? The basic problem for the employee is the lack of a specific contract with legally sufficient consideration and also the inherent nature of the employment-at-will doctrine. Courts are reluctant to create a wrongful termination cause of action if the employer aggressively asserts the two basic defenses of employment-at-will and the lack of a specific employment contract. This article provides a general overview of some successful litigation involving promises of employment. However, many traps for employees, such as compensation plans, are also briefly reviewed.*

### **Introduction**

In reviewing litigation concerning promises of employment, several variations of fraud including misrepresentation and concealment, are discussed. National Labor Relations Board (NLRB) standards may control in the event of replacement strikers. Next, contracts, implied, based upon expectancy, and promissory estoppel are noted. While compensation plans would appear to be a form of employment contract, they are not. The employment-at-will doctrine frequently prevails in worker termination cases, in spite of arguments to the contrary by the employee.

### **Fraudulent Misrepresentation**

Some jurisdictions have allowed the employee to assert fraudulent inducement in spite of the general employment-at-will doctrine.<sup>1</sup> In an Alabama decision, Barry Borum terminated his employment, sold his house and some possessions, and, at a cost and loss of approximately \$21,000, moved across the state of Alabama. He relied on an implied contract and was defrauded.<sup>2</sup>

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<sup>1</sup> See, e.g., *Meade v. Cedarapids, Inc.*, 164 F.3d 1218 (9th Cir. 1999) applying Oregon Law, *Wildes v. Pens Unlimited Co.*, 389 A.2d 837 (Me. 1978); *Stewart v. Jackson and Nash*, 976 F.2d 86 (2nd Cir. 1992) applying New York Law; *Lazar v. Superior Court*, 909 P.2d 981 (Cal. 1996).

<sup>2</sup> *Borum v. Alabama Inter-Forest Corporation*, 719 So.2d 851 (Ala. Civ. App. 1998).

While the Borum court granted summary judgment on the implied contract claim due to the employment-at-will doctrine, a cause of action for fraud in the inducement prior to employment was allowed. The company CEO had written a document that detailed salary, bonuses, and benefits. At trial the CEO stated that he did not intend to hire Borum. However, the CEO subsequently admitted under questioning that he did agree to a ninety day trial sales job.<sup>3</sup> The appellate court relied upon an Alabama Supreme Court decision<sup>4</sup> that allowed a fraud in the inducement action prior to employment.

An Arkansas court reached a similar conclusion. John Houser asserted that he quit his job in response to an offer to open and manage a new restaurant named John's Diner.<sup>5</sup> Houser cleaned the facility, hired employees, purchased food and supplies and opened John's Diner (self-named) on October 31, 1989. On November 3, 1989, Houser and his entire staff were fired, supposedly for not following a company policy that required employees to pay for coffee and tea that they consumed. On November 6, 1989, with a new manager and staff, the restaurant continued operating as a diner.

A jury awarded Houser joint and several damages against the individual who had employed Houser (Wayne Stowe) and the employer (Interstate Freeway Services, Inc.) in the amount of \$27,872.00 in compensatory damages, \$2787.00 in punitive damages, and \$104.21 in statutory costs.<sup>6</sup> The Arkansas Supreme Court affirmed the jury's fraud verdict but reduced the compensatory damages to an amount (\$14,347.00) for the time that John's Diner was actually open.<sup>7</sup>

The Court wrote:

“in fraudulent inducement of employment cases, under the benefit of the bargain measure the defrauded employee receives the benefits he would have realized under the contract had the representations been true. Under the out-of-pocket measure, the focus is on compensating the injured party for the pecuniary loss sustained as a result of the fraud. Further, the difficulty in application of these theories is increased by the fact that this is an employment-at-will case, in that there is no set length of employment.

We note with approval the approach taken in the case of *Berger v. Security Pacific Inf. Systems*, 795 P.2d 1380 (Colo. App, 1990), where an at-will employee who established that her employer had fraudulently concealed that the project for which she had been hired to manage might be terminated, was entitled to lost wages from the project's termination; although the employee's employment was terminable at will, the jury could reasonable infer from the

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<sup>3</sup> 719 So.2d at 853.

<sup>4</sup> *Kidder v. AmSouth Bank, N.A.*, 639 So.2d 1361 (Ala. 1994).

<sup>5</sup> *Interstate Freeway Services Inc., and Wayne E. Stowe v. John Houser*, 835 S.W.2d 872 (Ark. 1992).

<sup>6</sup> 835 S.W.2d 872 at 875.

<sup>7</sup> 835 S.W.2d 872 at 884.

evidence that her employment would have continued for a reasonable time had the project been as successful as represented by the employer.”<sup>8</sup>

Oregon also recognizes a fraud theory of recovery when employment prospects are misrepresented. The Supreme Court of Oregon in 2013 decided *Cocchiara v. Lithia Motors, Inc.*<sup>9</sup> The Oregon Supreme Court stated that an at-will employee could pursue promissory estoppel and fraudulent misrepresentation claims against an employer.<sup>10</sup> A salesperson told his manager that he was leaving for a new position. After a heart attack, he needed a less stressful job. The manager told him that a new “corporate” position was available and confirmed that the employee definitely had been granted the position. In reliance upon this, the employee turned down the new position. However, the employee was never hired.

The Oregon Supreme Court noted that employment-at-will focuses on termination and not new employment.<sup>11</sup> Acknowledging that Oregon is an employment-at-will jurisdiction does not prevent actions for deceit against a prospective employer when justifiable reliance and damages are proven.<sup>12</sup>

### **Fraudulent Concealment**

Roberta Berger in 1985 was offered employment in disaster recovery by her former employer, Security Pacific Corporation, and moved to Denver in 1986 from New Orleans and gave up her effort to start her own disaster recovery business.<sup>13</sup> When Berger “...expressed concern about her job security, Mitchell [the interviewer] assured her that she had nothing to worry about and that she would always have a place with the company.”<sup>14</sup> The interviewer knew, but did not disclose, that the disaster recovery business division that was employing Berger was at risk of being discontinued.<sup>15</sup>

After Berger had completed only seven months on the job, the division was closed and Berger was terminated. She lost to foreclosure the home that she had purchased in Denver and incurred relocation expenses in moving to another state when she had been offered employment.<sup>16</sup> She sued Security Pacific Corporation for fraudulent concealment.

While the employer argued that it had no duty to disclose financial information, the Colorado Court of Appeals wrote:

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<sup>8</sup> 835 S.W.2d at 874-875.

<sup>9</sup> *Cocchiari v. Lithia Motors, Inc.*, 297 P.3d 1277 (Or. 2013).

<sup>10</sup> 297 P.3d 1277 at 1298.

<sup>11</sup> 297 P.3d 1277 at 1301.

<sup>12</sup> 297 P.3d 1277 at 1302.

<sup>13</sup> *Berger v. Security Pacific Information Systems, Inc.*, 795 P.2d 1380 (Colo. Ct. App. 1990).

<sup>14</sup> 795 P.2d at 1382.

<sup>15</sup> 795 P.2d at 1382.

<sup>16</sup> 795 P.2d at 1383.

“stated generally, a person has a duty to disclose to another with whom he deals facts that “in equity or good conscience” should be disclosed. [Citation omitted.] Under Restatement (Second) of Torts § 551-(2) (e) (1965), one party to a business transaction has a duty to disclose to the other “facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other because of the relationship between them, the customs of the trade, or other objective circumstances would reasonably expect a disclosure of those facts.” [Citation omitted.] More specifically a party has a duty to disclose if he has stated facts that he knows will create a false impression unless other facts are disclosed.” [Citation omitted.]<sup>17</sup>

The Colorado Court of Appeals continued that “an employer’s right to terminate an at-will employee at any time without cause is not inconsistent with an action for fraudulently inducing such employee’s acceptance of employment. [Citation omitted.] An employer’s right to terminate an at-will employee without cause does not protect the employer from liability for fraud in inducing the employee to accept employment.”<sup>18</sup> The Court upheld a verdict for compensatory damages in the amount of \$91,631.00 (lost wages and the loss on the house).<sup>19</sup>

An Oklahoma Court of Civil Appeals in 2007 also addressed the issue of false statements made by an employment interviewer. Christopher Stehm, while being interviewed, was assured that the division received substantial revenue from a contract with Gulfstream Aircraft. Stehm learned after employment that this was a knowingly false statement. When he was terminated after eight months of employment, Stehm sued for fraudulent misrepresentation and concealment of client information.<sup>20</sup>

The Oklahoma Court of Civil Appeals cited Berger’s<sup>21</sup> reasoning and “extend[ed] the duty to an Oklahoma employer to assure that the information disclosed to a prospective employee during the pre-hiring/recruitment process is not false or misleading. This duty is not vitiated by appellant’s at-will employment status because appellant did not challenge his termination from employment. Instead, appellant alleged he was induced to leave his secure job with Gardner Denver by the employer’s misrepresentation during hiring.”<sup>22</sup>

Regarding ratification, the Oklahoma Court of Civil Appeals stated: “there appears no evidence in this record that appellant affirmatively ratified his continued employment under new terms or subject to additional benefits after discovering the alleged fraud. Instead, the record shows appellant simply performed his employment obligations under the terms originally

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<sup>17</sup> 795 P.2d at 1383.

<sup>18</sup> 795 P.2d at 1384.

<sup>19</sup> 795 P.2d at 1385.

<sup>20</sup> Stehm v. The Nordam Group, Inc., 170 P.3d 546 (OK. Civ. App. 2007).

<sup>21</sup> Supra.

<sup>22</sup> 170 P.3d.at 548.

negotiated and agreed upon prior to his discovery of the alleged fraud. [Citation omitted.]”<sup>23</sup> The Court reversed a grant of summary judgment in favor of the employer.<sup>24</sup>

### **Replacement Workers for Strikers**

On November 1, 1981, Blincoe Packing Company workers in Idaho went on strike. On November 4, 5, and 6 replacement workers were hired and promised that they would not be fired if the strike settled. When the strike was settled the replacement workers were terminated on November 12. At trial, the plaintiffs were awarded compensatory and punitive damages, without discussing the substantive law of wrongful termination.<sup>25</sup>

A similar decision was reached by the Nebraska Supreme Court in 1998.<sup>26</sup> Here, the Return to Work Resolution summarized promises made to the replacement workers concerning retained employment and that the company would protect them from harassment. A specific statement in the resolution stated: “there shall be no intimidation, discrimination, or harassment because of any person’s participation or non-participation in the strike.”<sup>27</sup> Because of harassment, almost all of the replacement workers resigned. The Court reversed summary judgment for the employer.

The Nebraska Supreme Court noted that in *Belknap, Inc., v. Hale*, 463 U.S. 491 (1983), the U.S. Supreme Court held that a claim for misrepresentation is not preempted by the NLRA.<sup>28</sup> In fact, the U.S. Supreme Court’s *Belknap* decision is frequently quoted for the proposition that a state cause of action is allowed in an area arguably subject to the National Labor Relations Act “if the behavior to be regulated is behavior that is only peripheral to the federal law or touches interests deeply rooted in local feeling or responsibility.”<sup>29</sup>

### **Implied Contract**

A cause of action may exist for the breach of an implied employment contract. Consider the following case. John Lanier in the late 1960s was a sales representative for General Electric Company.<sup>30</sup> Lanier was approached by a branch manager for Alenco, a Division of Redman Industries, Inc., and promised a substantial raise if he became a sales manager at Alenco. According to the trial court, Lanier obtained a one year oral employment contract from July, 1969 until July, 1970. However, he was discharged without justification after six months of employment in January, 1970. He sued for the balance due under the contract. The Court wrote that “Lanier, with a wife and four children, left a secure and well-paying position with General

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<sup>23</sup> 170 P.3d at 548.

<sup>24</sup> 170 P.3d at 549.

<sup>25</sup> *Verway v. Blincoe Packing Co.*, 698 P.2d 337 (Idaho, 1985).

<sup>26</sup> *Foreman v. As Mid-Am., Inc.*, 586 N.W.2d 290 (Neb. 1998).

<sup>27</sup> 586 N.W.2d at 294.

<sup>28</sup> 586 N.W.2d at 295.

<sup>29</sup> *Sawyer v. E.I. Dupont De Nemours and Co.*, 2007 U.S. Dist. LEXIS 30041 (S.D. Tex. 2007) Citing *Belknap, Inc., v. Hale*, 463 U.S. 491, at 497 (1983).

<sup>30</sup> *Lanier v. Alenco*, 459 F.2d 689 (Fifth Cir. 1972).

Electric.... We find it unlikely that Lanier would leave that sort of employment without some substantial representation of a secure position at Alenco.”<sup>31</sup>

The Court continued:

“Employment at will does not have much security, particularly when there is testimony in the record from former Alenco employees that Alenco had a history of discharges without cause. Furthermore, it does not appear that Lanier was precipitous in his shift of employment to Alenco, for his negotiations with Shelton took longer than one year. Lanier immediately assumed functions at Alenco’s New Orleans Branch commensurate with his explanation of the contract with Shelton, taking into consideration the newness of the branch operation. There is nothing in the record to indicate that Lanier was an unsatisfactory employee. We conclude that these factors are not, as a matter of law, insufficient ‘corroborating circumstances’ to overturn the trial court’s judgment that Lanier and Shelton agreed upon an oral contract of employment for a fixed term of one year at certain salary and commission levels, including “start up” commissions.”<sup>32</sup>

A California Court of Appeals decision in 2008 reached a similar result. Arthur Stillwell was a Salvation Army employee from 1962 until 1977 and again from 1987 until 2003, when his employment was terminated. A 1998 written employment agreement stated that the employment was at-will. The Court’s opinion does not provide any explanation of the facts surrounding Stillwell’s discharge. However, Stillwell sued, asserting that the Salvation Army breached an implied employment contract to terminate him only for good cause.<sup>33</sup>

While the decision was primarily based upon procedure, the California Court of Appeals did find substantial evidence to uphold the jury’s verdict to only terminate Stillwell for good cause. In addition to verbal and written assurances that asserted that there would be many years of employment, there was evidence that the Salvation Army only terminated employees for good cause. While several employee handbooks characterized the relationship as being at-will, the handbooks also stated that if factors beyond the Salvations Army’s control developed, “every effort will be made to place the employee in another department...with release only as a last resort.”<sup>34</sup> A new trial was granted due to an inconsistent jury verdict that determined Stillwell had both an express contract and an implied contract.<sup>35</sup>

### **Legitimate Expectations**

When Charles Toussaint was terminated by Blue Cross and Blue Shield of Michigan, he asserted that he could only be terminated for good cause.<sup>36</sup> In this case, a Blue Cross employee

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<sup>31</sup> Lanier v. Alenco, 459 F.2d 689 (Fifth Cir. 1972).

<sup>32</sup> 459 F.2d at 691.

<sup>33</sup> Stillwell v. Salvation Army, 167 Cal. App. 4<sup>th</sup> 360 (Cal. Ct. App. 2008).

<sup>34</sup> 167 Cal. App. 4<sup>th</sup> at 364.

<sup>35</sup> 167 Cal. App. 4<sup>th</sup> at 365.

<sup>36</sup> Toussaint v. Blue Cross and Blue Shield of Michigan, 292 N.W.2d 880 (Mich. 1980).

manual indicated that it was the “policy” of the company to release employees “for just cause only.”<sup>37</sup> He received oral assurances that he would not be discharged "as long as I did my job" or "[I was] doing the job"<sup>38</sup>

When Toussaint was hired in 1967 he was given a Supervisors Manual and a Guidelines pamphlet that contained discipline and termination procedures. In 1972 his employment was terminated but the procedures contained in the documents that he was given were not followed. A jury returned a \$73,000 verdict for Toussaint and his employer appealed.<sup>39</sup>

The Michigan Supreme Court in their 1980 decision wrote:

“While an employer need not establish personnel policies or practices, where an employer chooses to establish such policies and practices and makes them known to its employees, the employment relationship is presumably enhanced. The employer secures an orderly, cooperative and loyal work force, and the employee the peace of mind associated with job security and the conviction that he will be treated fairly. No pre-employment negotiations need take place and the parties’ minds need not meet on the subject; nor does it matter that the employee knows nothing of the particulars of the employer’s policies and practices or that the employer may change them unilaterally. It is enough that the employer chooses, presumably in its own interest, to create an environment in which the employee believes that, whatever the personnel policies and practices, they are established and official at any given time, purport to be fair, and are applied consistently and uniformly to each employee. The employer has then created a situation “instinct with an obligation.” [Footnote omitted.]<sup>40</sup>

The Toussaint decision has received in excess of 1600 citations.<sup>41</sup>

In a 1993 decision, the Michigan Supreme Court applied similar logic in another decision. Dr. Rood worked for Chrysler Corporation as a salaried plant physician starting in 1970. In 1982 the plant was sold to General Dynamics Land Systems (GDLS) who retained Rood. However, a restructuring of responsibilities in 1985 resulted in Rood being forced to resign or be fired. Rood sued for breach of employment agreement, negligent evaluation, and breach of the covenant of good-faith and fair dealing. The trial court dismissed Rood’s claims except for breach of employment agreement. GDLS then requested summary judgment on the breach of employment agreement claim and this was granted by the trial court.<sup>42</sup> Rood appealed and the appeal was addressed by the Michigan Supreme Court.

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<sup>37</sup> 292 N.W.2d at 885.

<sup>38</sup> 292 N.W.2d at 886.

<sup>39</sup> 292 N.W.2d at 880.

<sup>40</sup> 292 N.W.2d at 892.

<sup>41</sup> *Shepard’s Citations*, Toussaint v. Blue Cross and Blue Shield of Michigan, 292 N.W.2d 880 (Mich. 1980), last visited May 20, 2016.

<sup>42</sup> Rood v. General Dynamics Corp., 507 N.W.2d 591 (Mich. 1993).

The Michigan Supreme Court noted that an employment contract could result from explicit promises or employer “policies and procedures that instill ‘legitimate expectations’ of job security.”<sup>43</sup> Reversing the trial court’s grant of summary judgment, Richard Rood’s case was allowed to go to the jury when he received a “Guide to Good Conduct,” an annual employee evaluation policy, and a policy concerning merit pay increases that collectively could allow the jury to decide that there was just cause employment.<sup>44</sup> However, the Court wrote that there must be “clear and specific employer policy statements, regarding employee discharge.”<sup>45</sup>

### **Promissory Estoppel**

Unlike the clear yes or no distinction in classical contract law where either a contract exists or it does not, promissory estoppel was designed to treat gifts as promises and was expanded to commercial contracts in which gratuitous promises produced reasonable reliance.<sup>46</sup> The following are several recent cases in which promissory estoppel was successfully asserted in an employment context.

Anthony D’Auito was dismissed from a police position with Amtrak as a result of his failure to disclose disciplinary actions when he was a Jersey City police officer.<sup>47</sup> He had retired in good standing from the Jersey City Police Department in 2004. After being hired by Amtrak in 2005, D’Auito terminated his employment with Continental Management, a public housing provider. Subsequently, an Amtrak background investigation obtained from the Jersey City Police Department a copy of D’Auito’s internal affairs file that indicated disciplinary matters not disclosed by D’Auito.<sup>48</sup> He was forced to resign his Amtrak position.

The U.S. District Court for the District of New Jersey allowed his promissory estoppel claim to survive Amtrak’s motion for summary judgment since Amtrak’s arguments were outside of their pleadings that were based solely upon D’Auito’s employment application and his consent to a background check.<sup>49</sup> Promissory estoppel may be based upon promises made independently of employment documentation.<sup>50</sup> Consequently, the District Court concluded that D’Auito’s promissory estoppel pleadings were sufficient to survive summary judgment. It is noteworthy that in the sequence of events the background investigation occurred after D’Auito had left his prior employment apparently in reliance on a promise of employment and after his Amtrak employment began.

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<sup>43</sup> 507 N.W. 2d at 598.

<sup>44</sup> 507 N.W.2d at 601

<sup>45</sup> 507 N.W.2d at 610.

<sup>46</sup> See, e.g., *Drennan v. Star Paving Co.*, 333 P.2d 757 (Cal. 1958).

<sup>47</sup> *D’Auito v. City of Jersey City*, 2007 U.S. Dist. LEXIS 57646 (D.C. N.J. 2007).

<sup>48</sup> 2007 U.S. Dist. LEXIS 57646 at 57654.

<sup>49</sup> 2007 U.S. Dist. LEXIS 57646 at 57655.

<sup>50</sup> 2007 U.S. Dist. LEXIS 57646 at 57655.

The U.S. District Court for the Western District of Texas applied promissory estoppel in a 2007 decision.<sup>51</sup> Edgar Hernandez resided in Chicago and was employed by Nestle as an industrial engineer. He had a telephone employment interview with three UPS HR and supervisory level managers. He subsequently received a written job offer from UPS as a management trainee in El Paso. He was assured by the UPS interviews that the position was his.<sup>52</sup>

However the written job offer stated:

“The relationship between UPS Supply Chain Solutions and its employees is at-will and the employee and UPS Supply Chain Solutions shall have the mutual right to terminate the employment relationship at any time for any reason, with or without cause, and without previous notice.”<sup>53</sup>

However, Hernandez sold his Chicago home and relocated from Illinois to Texas based upon the written offer and assurances from UPS. After several days of unpaid initial training in El Paso, he was told that the job offer would not be honored. He requested in this suit his out-of-pocket moving expenses based upon promissory estoppel.<sup>54</sup> The Court wrote: “The doctrine of promissory estoppel is an equitable doctrine adopted by Texas courts. [Citation omitted.] The doctrine enlists a three-prong test requiring plaintiff to show: (1) that UPS made a promise; (2) foreseeability by UPS that plaintiff would rely upon the promise; and (3) that plaintiff suffered substantial detrimental reliance upon UPS’s promise. [Citation omitted.] The doctrine may be applied where the promisor should reasonably expect the promise to induce the promisee into definite and substantial action or forbearance. [Citation omitted.] The reliance must be both reasonable and justified. [Citation omitted.]”<sup>55</sup>

Additionally, the Court noted that: “The state of Texas has a long-standing rule that at-will employment cannot support a claim for detrimental reliance for future conduct.”<sup>56</sup> In discussing promissory estoppel, the Court finds a “promise” in that “on July 5, 2006, UPS sent a letter to plaintiff, offering plaintiff the job of Management Trainee in UPS’s Engineering Department.”<sup>57</sup> Regarding “foreseeability,” the Court wrote: “Plaintiff worked and resided in Chicago when UPS made the promise for employment in El Paso. As such, UPS intended and requested that Plaintiff relocate. UPS should have reasonably expected that the promise of employment would induce plaintiff into terminating his employment with Nestle and moving to El Paso.”<sup>58</sup>

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<sup>51</sup> Hernandez v. UPS Supply Chain Solutions, Inc., 496 F. Supp.2d 778 (W.D. Tex. 2007).

<sup>52</sup> 496 F. Supp.2d 778.

<sup>53</sup> 496 F. Supp.2d 778 at 781.

<sup>54</sup> 496 F. Supp.2d 778.

<sup>55</sup> 496 F. Supp.2d 778 at 784.

<sup>56</sup> 496 F. Supp.2d 778 at 785.

<sup>57</sup> 496 F. Supp.2d 778 at 785.

<sup>58</sup> 496 F. Supp.2d 778 at 785.

The disputed element of promissory estoppel was “reasonable reliance.” The Court noted that “plaintiff’s reliance must be both reasonable and justified. [Citation omitted.] Reasonable reliance can be inferred by the facts and circumstances surrounding the promise and the actions taken by the plaintiff. [Citation omitted.] Plaintiff argues that he detrimentally relied upon the job offer when he resigned from Nestle and incurred relocating expenses moving to El Paso. In its response, UPS argued that plaintiff admits he was employed prior to his termination, because plaintiff states he “worked” for UPS for three days, and it thus barred from claiming reliance under the Texas at-will employment doctrine. Plaintiff retorted that he showed up for work and attended training and orientation, however, he was never officially employed nor paid for those days. The Court finds Plaintiff’s argument convincing.”<sup>59</sup> The Court granted judgment for Hernandez on the promissory estoppel claim. Noteworthy is the fact that had UPS paid Hernandez for the three day’s pay, he would have been subject to employment-at-will and unable to recover under the promissory estoppel theory.

In *Boule v. Pike Industries* a federal District Court applied Vermont law in reviewing an ambiguous letter agreement to determine if it constituted an enforceable employment contract.<sup>60</sup> The employment application that James Boule completed stated:

“I understand and agree that if hired, my employment will be at-will and may be terminated with or without notice at any time at my option or at the option of Pike. I understand that only a written agreement expressly to the contrary signed by me and the president of Pike Industries can vary this employment at-will policy. I agree to conform to the policies and procedures of Pike Industries.”<sup>61</sup> Additionally a training form signed by Boule stated that the company had an employment at will policy.

In 2011 Boule made a call to an independently operated Pike “Ethics and Compliance Hotline” seemingly complaining about possible age discrimination.<sup>62</sup> Subsequently Boule had a confrontation with a supervisor and was terminated.

Pike had a sixty-four page written employment manual that stated “It contains information about what you can expect from the company, and in turn what the company expects from you.”<sup>63</sup> While indicating that it was not a contract, the manual contained a detailed disciplinary procedure that apparently was not followed in Boule’s case. Boule’s challenge to his termination was based upon promissory estoppel.

While promissory estoppel claims rarely succeed in the employment arena the 2013 Boule decision of the District Court for the District of Vermont applied Vermont law to conclude that an at-will employee could establish a claim for wrongful termination under promissory estoppel.<sup>64</sup> Under Vermont law “Establishment of promissory estoppel requires (1) a promise on which the promisor reasonably expects the promisee to take action or forbearance of a substantial

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<sup>59</sup> 496 F. Supp.2d 778 at 785.

<sup>60</sup> *Boule v. Pike Industries*, 2013 U.S. Dist. LEXIS 26588 (D.C. Vermont 2013).

<sup>61</sup> 2013 U.S. Dist. LEXIS 26588.

<sup>62</sup> 2013 U.S. Dist. LEXIS 26588 at 26591.

<sup>63</sup> 2013 U.S. Dist. LEXIS 26588 at 26593.

<sup>64</sup> 2013 U.S. Dist. LEXIS 26588.

character; (2) the promise induced a definite and substantial action or forbearance; and (3) injustice can be avoided only through the enforcement of the promise."<sup>65</sup> The first two elements are for the finder of fact. In this particular situation, the employer had a hotline for safety concerns and had made assurances that an employee would not be retaliated against for reporting safety issues. Thus the employer's detailed policies created promissory estoppel assurances.

### Compensation Plans

While one might suppose that references to multi-year salaries imply multi-year employment, courts do not necessarily agree. The following are recent examples of compensation plan litigation.

At the time of employment the employer and employee, Norma Cruz and Visual Perceptions, LLC, signed a document that stated the amount of compensation, benefits and work schedule. Two months later a second document amended these terms and was also signed. Ten months later the employee submitted to the employer a handwritten list of employment changes. This resulted in a third document being signed on March 1, 2007, that became the subject of litigation.<sup>66</sup>

The document in question began: "Norma Cruz Employment Contract: This will cover the [thirty-six] month period starting April 1, 2007 and ending March 31, 2010."<sup>67</sup> It contained a statement of the work schedule, how salary and bonuses were to be calculated, and the benefits provided. The employee was described as a "salaried employee." The document provided for the number of allowable personal days and that the employer would pay for the employee's health insurance "for the duration of the contract."<sup>68</sup> The employer terminated the employee's employment on October 16, 2008.

The employee sued, asserting that she received a three-year employment contract that the employer breached. The employer replied that the document simply stated the terms and conditions of at-will employment. Both a trial court in a non-jury trial and an appellate court determined that the agreement was a three year employment contract. Considering the agreement to be unambiguous, these courts refused to consider extrinsic evidence beyond the words contained in the document. In contrast, the Connecticut Supreme Court decided that the document was ambiguous and might be interpreted either as a contract for a definite period of time or simply as a description of the conditions within an employment-at-will situation. Finding ambiguity, the Court remanded the case for a consideration of additional evidence outside the document to determine its meaning.<sup>69</sup>

The Connecticut Supreme Court observed that the time period could mean that the stated conditions applied if the employee were employed within that period. The "duration of the contract" language did not precisely state what period that "duration" was. If the agreement

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<sup>65</sup> 2013 U.S. Dist. LEXIS 26588.

<sup>66</sup> Cruz v. Visual Perceptions, LLC., 84 A.3d 828 (Conn. 2014)

<sup>67</sup> 84 A.3d 828.

<sup>68</sup> 84 A.3d 828 at 830.

<sup>69</sup> 84 A.3d 828 at 833.

continued to be ambiguous after considering the additional evidence, then the trial court could apply the rule that an agreement is interpreted against the party who wrote it (*contra proferentem*).

Another recent federal District Court for the Western District of New York decision involved a prospective employee who stated that he would not go to work for the prospective employer with anything less than a three-year employment contract.<sup>70</sup> The New York employer and employee signed a document labeled "Jack Lamb Compensation Plan" that contained salaries for three distinct years but did not explicitly state an employment duration.<sup>71</sup> When the employee was fired after six months, he sued alleging breach of contract. The federal District Court for the Western District of New York dismissed the lawsuit, finding that the agreement was unambiguous. Prior New York state court decisions held that a statement of compensation for a particular period of time does not require the employer to continue employment for any duration. Consequently, the statements made prior to signing the agreement would not be admissible in evidence.

The Second Circuit reached a similar conclusion in 2014.<sup>72</sup> Felix Montalvo became an Operations Manager for Keystone Automotive Industries, Inc. in 2013. The contract in question mentioned three years' salary but additionally stated that nothing in the salary paragraph was intended to amend the employment-at-will status between the parties. Montalvo was terminated after four months employment and sued for breach of contract. Both the federal District Court and the Second Circuit found the contract to be unambiguous and at will. Additionally, the Second circuit stated, any asserted implied obligation of good faith and fair dealing may not be applied in a manner that contracts the contract.<sup>73</sup>

### **Conclusion and Observations**

The cases discussed in this article that ruled in favor of the employee are rare exceptions. The assertions and promises made by the employer may be vague and reliance may also be difficult to establish. If one seeks a pre-employment remedy, such as reimbursement of moving expenses, it may be possible to avoid the employment-at-will doctrine, but this also is rare. The implied covenant of good faith and fair dealing is also rarely allowed in promises of employment cases.<sup>74</sup>

In the 2006 case, *Matagorda County Hospital District v. Burwell*, the Texas Supreme Court held that a statement in a personnel manual that "employees may be dismissed for cause" did not modify employment-at-will.<sup>75</sup> This decision is in line with a prior decision, *Montgomery County Hospital District v. Brown*, that at-will employment can't be modified by an employer's oral assurances that an employee whose work is satisfactory will not be terminated without good

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<sup>70</sup> *Lamb v. Money Transfer Systems, Inc.*, 2103 U.S. Dist. LEXIS 132007 (D.C.W.D. N.Y. 2013).

<sup>71</sup> 2103 U.S. Dist. LEXIS 132007 at 132013.

<sup>72</sup> *Keystone Automotive Industries, Inc. v. Montavo*, 2014 U.S. Dist. LEXIS 101305 (C.A.2d 2014).

<sup>73</sup> 2014 U.S. Dist. LEXIS 101305 at 101312.

<sup>74</sup> See, *Hobbs v. Pacific Hide and Fur Depot*, 771 P.2d 125 (Mont. 1989) for a case reversing a verdict in favor of the employer.

<sup>75</sup> *Matagorda Country Hospital District v. Burwell*, 189 S.W.3d 738 (Tex. 2006).

cause. The employer told Plaintiff that she would not be fired "as long as [she] was doing [her] job and . . . unless there was a good reason or good cause to fire [her]." <sup>76</sup> The Court wrote: "an employee who has no formal agreement with his employer cannot construct one out of indefinite comments, encouragements, or assurances."<sup>77</sup>

The 2006 Matagorda County Hospital District decision has been cited in more than 50 subsequent cases.<sup>78</sup> For example, *Shorter v. Peaches Uniform, Inc.*, a federal District Court for the Central District of California decision, applying Texas law, favorably cited this case.<sup>79</sup> In the *Peaches Uniforms* case, the employee had worked for the employer since 1987 and was requested to sign an acknowledgement in the employee handbook that Plaintiff's employment was "at-will." The employee responded that she should be terminable only for cause because she had worked for the employer for a long time. The employer refused to change the "at-will" acknowledgement in the handbook, but allegedly stated that Plaintiff "would not have to worry about it." Approximately nine months later she was fired and the employer was granted summary judgment when the former employee sued.

Does this give the employer a license to lie? Should employees believe any promise of employment? Arguably there is not a license to lie, but the lack of specific promises and lack of clear contractual language that overcomes the employment-at-will doctrine defeats most claims. Courts place great weight on written statements in employment applications and handbooks that employment is at-will. Contrary assurances are frequently considered by courts to be, it seems, the functional equivalent of non-binding "sales talk."

Outright classical fraud involving very specific false promises, verbal as well as written, appears to be the biggest weapon in the employee's arsenal. However, integration clauses and "entire agreement" language in written documents might overcome even this. Contradictory statements and elaborate disciplinary procedures contained in employers' handouts and handbooks may sometimes be utilized against the employer. From the employer's prospective, repeated statements that employment is at-will combined with streamlined "bare bones" documents seem to be the best approach.

The foreseeable legal future appears to be a pro-employer legal period. Without the resurgence of unionism and union contracts, successful employee litigation is likely to be very rare. Hence, seeming "employment contracts" are mere words. Workers face many traps when they rely upon the goodwill of employers to disregard employment at will. Trust but verify.

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<sup>76</sup> *Montgomery Country Hospital District v. Brown*, 965 S.W.2d 501 (Tex. 1998).

<sup>77</sup> 965 S.W.2d at 502.

<sup>78</sup> *Matagorda Country Hospital District v. Burwell*, 189 S.W.3d 738 (Tex. 2006), *Shepard's Citation*. LexisNexis, last accessed June 1, 2016.

<sup>79</sup> *Shorter v. Peaches Uniforms, Inc.*, 2013 U.S. District LEXIS 9228 (D.C.E.D. Cal. 2013).



## **MEDICAID EXPANSION AND ACTIVITY BASED COSTING AS A MEANS OF MEASURING EFFICIENCY AND IMPROVEMENT IN HEALTHCARE**

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### **Abstract**

*Currently, the healthcare system does not use a universal accounting method that consistently and accurately determines prices for services and procedures; therefore the reimbursements and rates set and paid by all participants (insurers, politicians, insured) are inconsistent, and may be unreliable. In addition, healthcare participants are demanding that healthcare shift the measurements of successful treatment from treatment-based to outcome-based, thus extending treatment duration and creating new measurable costs. Healthcare participants use essential words such as costs, charges, payments, and expenditures interchangeably. These words have significant implications when used in varying contexts by different professions. Before the expansion brought on by the Affordable Care Act (ACA), the Medicaid system was afflicted with costing difficulties that had not yet been addressed. The expansion of Medicaid through the ACA necessitates the adoption of a universal method of accounting; activity based costing (ABC), as one means of improving cost accounting efficiency. Healthcare participants require a deeper understanding of the accounting associated with healthcare and must agree on the semantics involved in healthcare to eliminate the confusion and controversy surrounding healthcare reimbursement and measurement. Otherwise, expanding Medicaid through the ACA will amplify issues, especially the utilization of cost accounting to efficiently and accurately measure the new costs for efficient management of the costs.*

## **The ACA and the Medicaid Caper Issues with Medicaid**

From inception, Medicaid has battled issues such as widespread fraud, budgeting and physician retention and recruiting. According to the U.S. States Attorney Office, the frauds can be as simple as intentional overbilling and as complicated as fabricating home hospice care. One fraudulent perpetration included fabricating billing to the D.C. and Maryland Medicaid program for more than \$75 million (Attorney General, 2014). In response to these frauds, the Offices of Medicaid Inspector General (OMIG) have appeared across the nation (Wenik, 2010). To indicate the level of support for improving Medicaid billing and fraud prevention the offices were established at the state level and target Medicaid fraud and abuse with auditing and investigative resources (Wenik, 2010). If a state employs an OMIG, the state mitigates or eliminates the potential for a healthcare entity to commit fraud with auditing and investigative actions. The OMIG also mitigates criminal prosecution for unintentional misrepresentation, over-billing, or other Medicaid claim issues through self-reporting and self-disclosure (Wenik, 2010).

Budgeting for Medicaid on a state and federal level remains an ongoing issue. Funding for Medicaid is based on expected costs that incorporate unforeseen costs (Susswein, 2001). Because healthcare budgets on predictable numbers and unforeseen expenditures, with unforeseen expenditures being a number based on an assumption about potential costs, healthcare has regularly outpaced available funds (Susswein, 2001). It is difficult for any organization to budget for healthcare costs when considering the presence of unpredictable variations (Aaron, 2009). Unpredictable variations, coupled with a changing environment and the natural heterogeneous nature of healthcare, create a chaotic environment for budget creation and require a rolling forecast (Coulmas & Law, 2010). ABC will allow the measurement of the variations so that they can better controlled.

In order to increase the healthcare system's adaptability, not only does the healthcare system need to use a more efficient costing model, such as activity based costing for cost reductions and improved cost management, there should also be activity based budgeting to advance continuous improvements, facilitate cost and activity management, and increase efficiencies (Coulmas & Law, 2010). Activity based budgeting identifies and links operation's key activities with drivers and produces an integrated view of the business that allows management to focus on incremental improvements rather than budgeted targets. Financial performance is important, but managerial control over improvements is imperative for improving operations. ABC will help identify the variable costs to facilitate more accurate budgets.

### **Physician Payments**

Medicaid's biggest issue is attracting and retaining quality physicians. Medicaid's low reimbursement amounts, administrative burdens and delayed payments discourage physician participation and leads to a shortage of quality, and available physicians (Cunningham & O'Malley, 2009). Despite attempts to increase reimbursement rates, Congress has been unable to offset the negative effects of delayed payments and administrative burdens in order to attract physicians (Cunningham & O'Malley, 2009). Implementing a sound accounting method will not only strengthen the healthcare system's financial position, but also attract physicians, and empower them. In the medical community, there is an absence of fundamental understanding about what it costs to deliver complete patient care. This lack of understanding specific costs leaves the providers unable to implement reliable cost reductions or effectively link cost to process improvements or outcomes (Kaplan & Porter, 2011). Activity based costing helps

identify the costs which change by activity, such as individual patient treatment modalities, and this allows the assignment and control of new costs. Implementing activity based costing, along with shifting to outcome-based care means “value in healthcare is measured in terms of the patient outcomes achieved per dollar expended” (Kaplan & Porter, 2011, p. 49).

### **ACA Expansion and Cost Implications**

Before the ACA Medicaid expansion, Medicaid eligibility requirements were determined at the state level and decided by income, age, gender, dependents, and other specific requirements (Musumeci, 2014). The 27 states that chose to expand Medicaid now have uniform eligibility requirements determined by the same requisites (Musumeci, 2014). Until now, the main groups of people served by the Medicaid program have been low-income parents and children, the elderly and the disabled, meeting requirements determined by the individual state (Musumeci, 2014). With the expansion, those eligible for Medicaid now include, nondisabled persons under 65 years of age with household incomes under 133 % (with a five percent buffer making it 138 % of the federal poverty level, or approximately \$14,850 for an individual and \$30,650 for a family of four (Esposito, 2012).

The expansion creates two new groups. The first group is the newly eligible individuals, which includes most nonelderly individuals that are United States citizens or are lawfully present immigrants that have been in country for at least five years with household incomes under 133(138) % (Centers for Medicare & Medicaid Services, n.d.). The second group is the woodwork “group”, which are the individuals that were previously eligible but did not apply until the expansion (Carroll, 2013). The federal government will pay 100 % of the cost of the expansion for the newly eligible until 2020 for states that have opted to expand, but the woodwork population will not be covered by the new expansion budget (Carroll, 2013). This leaves the expansion states responsible for the second population.

### **Reimbursements versus Costs**

#### **Reimbursement Rates**

Reimbursement rates are set by the Center for Medicare and Medicaid Services (CMS) and based on suggestions made by the American Medical Association (AMA) (Whoriskey & Keating, 2013). The AMA, an organization composed exclusively of physicians, organizes a confidential meeting annually to prescribe a value on medical care and recommended to the CMS based on the time and intensity of the services of care (Whoriskey & Keating, 2013). The basis for the determination of the values, known as “relative value units” (RVU), comes from a report requisitioned in the late 1980s called the resource-based relative value scale (RBRVS), created by Peter Braun and William Hsaio (Whoriskey & Keating, 2013). The RBRVS was a report created at Harvard University to determine a rate of pay for medical providers (Hsaio, 1988). It was published in 1988, and officially adopted in 1992 (Hsaio, 1988). The AMA employs a sub-committee, known as the Relative Value Update Committee (RUC), to make regular recommendations concerning updates to the RBRVS for the CMS regarding RVUs (Whoriskey & Keating, 2013). This committee is made up of 25 specialty physicians, but does not encompass all specialties or general practice (Whoriskey & Keating, 2013). This current

method of valuing reimbursements is unsatisfactory due to the structural inequities and is under review by the Urban Institute and the RAND Corporation at the request of the CMS ("American Academy of Sleep Medicine," 2013).

### **Federal Medical Assistant Percentage**

Medicaid is a joint federal-state program, which reimburses states at a matching rate determined by a formula called the Federal Medical Assistant Percentage. Federal Medical Assistance Percentages (FMAPs) are used to determine the amount of funds the federal government will match per state for Medicaid expenditures, and has long been criticized for inadequately addressing a state's fiscal capacity (Peters, 2008). The FMAP is set by a state's per capita income, which includes resident's wages, rents, and interest income (Peters, 2008). However, it omits information such as income from energy exports for Alaska and Wyoming, and income from housing multiple corporate headquarters for Delaware, and this causes an inaccurate depiction of a state's true financial position (Peters, 2008). In addition, FMAP does not consider the cost of providing healthcare to different recipients (Peters, 2008). Different medical recipients require various services at different monetary investments; for instance it is more costly to service the elderly than adults and children. In 2008, the average Medicaid amount spent for a child beneficiary was \$2,571, for an elderly beneficiary it was \$16,984 and for a disabled beneficiary was \$17,332 (Iglehart, 2012). The Federal Medical Assistant Package does not capture the disproportionate costs of servicing different sectors of the populations.

### **Fee-for-Service: An Effective Means of Payment Compared to Costing.**

The healthcare industry is shifting from a fee-for-service payment model to a managed care model (Centers for Medicare & Medicaid Services, 2015). The fee-for-service payment model has been credited with creating a treatment environment that facilitates unnecessary testing and treatment, and subsequently unnecessary charges. In 2012, Consumer Reports revealed that 12 commonly overused tests, including EKGs and other familiar imaging tests, cost \$6.8 billion dollars (Consumer Reports, 2012). The fee-for-service payment model has also been accused of creating an environment that encourages perverse incentives to accommodate treatment plans that better suit reimbursement plans rather than patient care. At Intermountain Healthcare, an evidenced-based healthcare facility, a redesign of a treatment process that reduced the necessity to transport newborns to the NICU caused its net operating income to decrease substantially (Clark, Savitz, & Pingree, 2010), but Intermountain found a way to reduce the necessity for newborns with a particular condition to be transported from the birth hospital to an off-site NICU (Clark et al., 2010). Although there was a loss in income, when the babies were transferred to another hospital, they create care based on evidence based treatment and also decreased costs to the transferring hospital. (Clark et al., 2010). In addition to health organizations improving care with the shift to a managed care model and outcome-based payments, physicians will no longer feel compelled to perform unnecessary procedures which do not impact the outcome of the patient's recovery. Instead, it will become even more apparent that accurate costing measures for reimbursement are imperative for cost/benefit measured by individual patients, further encouraging adoption of the ABC accounting method.

## **Managed Care Model**

The Managed Care Organization (MCO) is best understood as affiliations of healthcare providers that are capable of simultaneously reducing healthcare costs while improving the quality of care (Greaney, 2011). MCOs accomplish this by providing preventative care, negotiating fees with providers, and cost sharing (Greaney, 2011). An MCO functions much like an HMO, accepting a monthly capitated rate from the state in exchange for providing most Medicaid benefits to qualified beneficiaries. Contrary to the fee-for-service model, the managed care program requires that fees be paid regardless of services rendered (Leemon, 2014). However, there are inherent risks with this payment structure. If a high volume of Medicaid beneficiaries requires expensive long-term care at one time, the capitated rate may not cover the costs, subsequently creating a loss for the provider (Leemon, 2014). The managed care system is potentially more lucrative, but it requires an appropriate balance between the state's risk of overpaying fees and the managed care organization's risk of not receiving enough in fees (Leemon, 2014). As a result, this managed care method requires meticulously assessed rates derived from accurately obtain numbers using a reliable accounting method, and ABC is one means of cost efficiency improvement.

## **What is Activity Based Costing?**

### **Activity Based Costing**

Businesses have known for years that some costs increased with business activity. Before computers became widely utilized for accounting purposes the cost of tracking these minor cost changes associated with increased activity were prohibitive. This resulted in all costs being classified as fixed or variable and the small activity based costs were lumped together and relegated to overhead. The cost of obtaining the enhanced information related to a change in activity in a manual accounting system exceeded the value of the information. The advent of computers made the tracking of small cost changes, directly related to the business activity, an effort that is worthwhile. In today's competitive environment the smallest of costs can have significant impact on profit when a large volume of activity is involved. Small cost changes directly correlated to large changes in activity may have a substantial impact on the bottom line, and it therefore becomes beneficial and practical to track all costs. This will lead to and either minimizing or eliminating the activity based costs.

The Healthcare Industry has historically been able to bill necessary costs to cover all expenses including wasted materials, human inefficiency, and the improper use of assets attributed to the fact that individuals often have not questioned the doctor's bill when their health was at risk and insurance companies have covered the bills. The trend toward reduced reimbursements for healthcare services by the government and the insurance companies has caused healthcare organizations to reexamine their practices. They now more accurately trace costs, and effectively embark on efforts to ensure all expenditures are cost effective and are reduced in order to sustain effective healthcare.

Computers enable the tracking of costs to individual patients, throughout a healthcare episode, through each department, and track the costs related to the individual patient in each department. Costs can be broken down to include any item that is entered into the patient care system. The cost tracking can include the services being charged for any professional who

interacts with the patient charged by the time actually spent with the patient, the cost of all services provided for the patient, and the cost of the medicines and other supplies used for the patient's treatment. This capability is allowing healthcare organizations to review the time spent by the patient in different treatment modalities, facility usage, and health care provider's time spent for each treatment episode. This information will allow healthcare organizations to focus on patient treatment costs and show where the greatest benefits can be attained through changes in treatments which lead to a more efficient treatment process leading to better patient health.

The activity based system can also track costs incurred with the passage of time, such as costs incurred due to expiration of products and product spoilage. This tracking ability will allow better budgeting and expenditures within a hospital or clinic, and should lead to hospitals and clinics pooling resources to ensure proper patient care while controlling order quantities, storage, and reducing expenses caused by time. Healthcare Participants include third-party payers, politicians and policy makers, physicians and consumers of healthcare. The healthcare participants all use terms such as costs, charges, payments, and expenditures interchangeably (Carpenter, 2012). Medicare released a report that concluded the Part B costs had been growing at a slower rate, however, the term "costs" should have been "expenditures." Costs are resources used towards the production of goods and services; expenditures are disbursements or payments (Ng, 2013). Healthcare participants talk about the same subjects, for example costs, in different contexts. When politicians and policy makers often discuss "bending the cost curve" with other key healthcare participants, they are referring to reducing what the government is paying to providers, the costs to the government, and not about reducing the costs of providing healthcare services (Kaplan & Porter, 2011). Clear, concise and effective policy and direction cannot be made if healthcare participants do not understand the meaning of the discussion. Definitions are critical in the continuing healthcare debate and therefore should be clearly defined.

## **Defining Activity Based Costing**

### **Costing Methods**

The healthcare industry traditionally uses the absorption method, which is the process of allocating apportioned overhead costs to a specified department by a predetermined unit until all costs are absorbed. Another popular method is the allocation method. With the allocation method, cost centers are determined, and a percentage of the overhead is assigned to each cost center. Using these seemingly arbitrary assignments leads to distorted internal financial reporting. In a homogeneous environment, where the consumption of resources is equal for all activities, these methods are acceptably accurate. However, the healthcare environment is heterogeneous in nature, requires disproportionate levels of service and supplies, and mandates a more specific accounting method to reflect accurately the cost of providing services to the consumer; "The healthcare industry has survived economically by cross-subsidizing margin shortfalls in one activity with the revenues generated from others" (Kaplan, 2013, para. 1). Patient charges have not accurately reflected the cost to treat in the healthcare system, until now, and has not measured or been held accountable to measure, the outcomes or value of treatment. Activity Based Costing identifies a cause and effect relationship by identifying a cost driver. The cost driver is the link between the activity and the cost and allows the activity to reflect the actual resource consumption. (Kaplan, 2013) Establishing accurate data on resource consumption per consumer with ABC will provide the healthcare industry with necessary data for pivotal decision-making about cost saving and quality improving behaviors.

Activity based costing reflects the true costs of care by identifying the actual costs of delivering care through linking cost drivers with activities. Moreover, ABC identifies the actionable cost savings from process improvement and advances the benefits from better utilization of capacity (Kaplan, 2013). Patient-outcome measures can be tied to costs that will promote improvements in the quality of outcomes and care, increase efficiency and capacity utilization, and inspire cost reduction (Kaplan, 2013). This will prove more effective in cost reduction and improving patient and provider conditions than simplistic actions such as arbitrary spending limits on discrete components of care and across-the-board cuts (Kaplan & Porter, 2011).

### **Activity Based Costing as a Solution for Healthcare Costing**

Reimbursements are arbitrary rates set by the AMA, an organization composed of an exclusive selection of specialty physicians that does not represent all the medical practices. The AMA is a collection of providers that share in the same confusion as all health participants, a fundamental misunderstanding of how to determine the cost of patient care and link it to outcomes. Because the providers are not accurately costing services, they cannot effectively price services or measure the value of outcomes. In addition to being unable to appropriately price services, the healthcare industry also lacks accurate, complete data with which to make crucial, strategic and potentially life related significant decisions.

Healthcare is moving towards MCOs and bundled payments, which mean the providers, are going to be paid to provide outcomes and not procedures or treatments. The shift in the industry comes from healthcare provider accountability for results. This leaves the fate of the profit margin squarely in the hands of accurately managing the costs with an effective accounting method and an effective budgeting method. In the past, fee-for-service allowed providers to perform procedures or services for payment and, in theory, if the outcomes were ineffective or undesirable it led to more revenues. The shift in the industry from fee-for-service will eliminate the potential for excessive treatment or procedure. The payment will require an outcome with an assigned value. If you purchase a blender and it is defective, you return it for an exchange or refund; it does not cost you more. Currently, if medical care does not create a positive outcome it creates more charges. The shift to MCO or bundle payments is not a revolutionary idea, but in order for it to be lucrative and effective for healthcare, the healthcare system will have to implement activity based costing because you can only manage what you can accurately measure.

“The dominant mode of physician payment in the US is fee-for-service (FFS), representing over 90 percent of primary care practice revenue predominately for office visits.” (Berenson & Rich, 2010). FFS encourages physicians to prescribe tests, procedures, and services which may not be necessary due to the fact that the more services they provide, the more revenue they earn.

Previous government and private insurance plans provided generous reimbursements for services provided to patients. (Aldhizer & Juras, Jan. 2015) The Fee For Service was set by each insuring entity with no collaboration on reimbursement rates among providers. The reimbursement rates were set without knowing the actual cost of providing the services. The Affordable Care Act established an incentive-based reimbursement model which will hopefully result in higher-quality care provided to patients at a lower cost. (Aldhizer & Juras, Jan. 2015) This lower cost and reimbursement rate, established by ACA, is set on estimates of costs with

little comparison to the actual cost of care. The lower reimbursement rates will require healthcare providers to very accurately track their actual cost of providing a service utilizing activity based costing which can provide an actual cost of the service to the provider. This will allow the provider to determine which services it can provide in a profitable manner in order to survive. If the providers' cost of service exceeds the reimbursement the provider will have to decide what cost it can cut to provide the service at a profit or if a service cannot be provided for less than the cost of the service the provider will have to stop providing the service or consolidate with other healthcare entities to provide improved quality of service at reduced costs to increase ACA Medicare reimbursement rates. (Aldhizer & Juras, Jan. 2015)

For an individual taking a blood thinning medication such as Warfarin, blood checks are required to ensure that the coagulation factor is within acceptable limits. "The test used to monitor the effects of warfarin is called the International Normalised Ratio, or INR. It is a blood test that checks how long it takes for blood to clot." (Warfarin, 2015) To determine the cost of this test in a doctor's office, the nurse or care assistant would utilize a portable testing device to perform the procedure, and the cost of the supplies actually utilized in the procedure would be added together to determine the cost. In some cases the patient will be self-monitoring and perform the test at home. (Warfarin, 2015) With either testing modality a lancet is utilized to cause a drop of blood to form on a finger and then the blood is transferred to the monitoring strip to determine the INR factor. The cost of this procedure would be at the doctor's office:  
 Cost of nurse's time: Yearly salary divided by 2,000 hours, (50 weeks at 40 hours per week) divided by 5 minutes of an hour.

Assuming a salary of \$60,000 / 2,000 equals \$30 per hour times 5/60 equals \$2.50 for the nurses time to which is added to the cost of a lancet, \$3.00, and the cost of a test strip, \$4.00, results in an activity based cost of the procedure \$9.50. As long as the Fee for Service exceeds the direct costs and no additional nurses or facilities are required to perform the service the test has a positive revenue contribution to the office and should be continued. If the costs exceed the FFS the procedure should not be performed in the doctor's office.

Portable home monitoring devices cost between \$1,500 and \$2,000 and the test strips cost approximately \$7.00 each. (Moll & Ansel, 2015) The costs of the equipment and supplies are covered by Medicare and the patient performs the exam, transmits the test results to the provider of the equipment, which in turn notifies the doctor's office.

As noted by Selivanoff, advances in technology, such as radio frequency identification devices in each product or device used in a treatment modality for a specific patient will allow the actual cost of products utilized to be traced to, and accurately added to the individual's cost of treatment. This specificity, coupled with the ability to monitor each healthcare professional's time spent with a patient, will allow activity based costing to become more accurate. (2011) Each new step in measuring actual patient costs will give an organization the ability to target the cost of patient care accurately, while providing the best care possible, a win-win outcome.

## **Conclusion**

Robert Kaplan (2013) states in his most recent initiative on how healthcare should be redesigned:

Once we stop cross-subsidizing healthcare delivery, we can build a reimbursement system that is accurate, transparent, and a stimulus for continuous improvements. A

value-based system that is based on knowledge of the efficient processes and costs incurred over an entire cycle of care will enable healthcare organizations to negotiate a fair price for care and be rewarded for delivering higher quality care at a lower cost (para 12).

Kaplan illustrates not only existing mistakes concerning current healthcare practices, but also a feasible and functional direction for effective solutions regarding the issues plaguing healthcare administration, including patient treatment value and reimbursements. The Obama Administration and Congress recognize the necessity for increasing reimbursements and retaining qualified physicians who deliver exceptional care. Subsequently, the healthcare industry must respond to this awareness with demands for reimbursement rates that are founded on supported, consistent and accurate costing that leads to acceptable pricing and valuable outcomes. Activity Based Costing will allow providers to obtain more accurate costing information on which to base their decisions about future operations. Providers must know the accurate cost of providing a service to make a decision on whether or not they can continue to provide the service. A cost-benefit analysis utilizing reimbursed fees versus the actual cost of the service provided by ABC will determine the future of healthcare practice.

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## ATTORNEY MISCONDUCT AND THE ROLE OF THE GRIEVANCE PROCESS IN CIVIL PROCEEDINGS ARISING FROM THE SAME FACTS

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### I. INTRODUCTION

The grievance process is administered and directed by the Office of the Chief Disciplinary Counsel and is dependent upon current and former clients and other third parties reporting alleged attorney misconduct. This reporting process is the first step in the grievance process and is done free of charge. The Plaintiff's legal malpractice attorney specializing in representing clients in lawsuits against their prior attorney has emerged as a boutique industry in the past few years. While attorneys are rarely held out as sympathetic figures, the use of the grievance process as a discovery tool weighs heavily against the former attorney and raises concern regarding the intent behind the use. Unfortunately for the attorney accused of violating the disciplinary rules, there is no recourse to stop a grievance investigation. Refusal to fully participate is a violation of the disciplinary rules. Determining whether the practice of filing a grievance in conjunction with a civil action is founded on preserving the ethical standards of the legal profession or is motivated by financial opportunity is the matter at issue.

### II. THE ATTORNEY GRIEVANCE PROCESS

Typically, a grievance against an attorney is initiated when an online grievance form is filled out and submitted online or printed and submitted to the State Bar of Texas –Office of the Chief Disciplinary Counsel (“CDC”) through standard mail.<sup>2</sup>The grievance form promulgated by the CDC is not always submitted.<sup>3</sup>Rather, the Plaintiff's Original Petition filed in a legal malpractice or civil barratry lawsuit is filed in lieu of a CDC grievance form.<sup>4</sup> Because an Original Petition filed in a civil lawsuit provides only notice pleading, a *prima facie* argument exists that notice pleading lacks sufficient facts for the CDC, after examination, to upgrade the pleadings to a Complaint.<sup>5</sup>When a filed Original Petition is forwarded to the CDC for examination it creates a peculiar predicament for both the responding attorney and the CDC.

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<sup>2</sup> Texas Rule of Disciplinary Procedure 1.06 (R) – “Grievance” means a written statement, from whatever source, apparently intended to allege Professional Misconduct by a lawyer, or lawyer disability, or both, received by the Office of the Chief Disciplinary Counsel.

<sup>3</sup> For purposes of this article, the term “legal malpractice attorney” references attorneys that have a Plaintiff oriented practice. They represent former clients in claims brought against prior legal counsel.

<sup>4</sup> It is possible that the grievance form will be submitted and the Original Petition is attached as an exhibit. Either way, the effect is the same in that the responding attorney will need to address the allegations made in the pleadings.

<sup>5</sup> Texas Rule of Disciplinary Procedure 2.10 – The Chief Disciplinary Counsel shall within thirty days examine each Grievance received to determine whether it constitutes an Inquiry or a Complaint.”

## A. (Responding attorney perspective)

Pursuant to Texas Rule of Civil Procedure 21(a), pleadings must state the grounds and the relief sought.<sup>6</sup>The purpose of the statute is for the pleadings to give fair notice of the claim and the relief that is being sought.<sup>7</sup>The CDC grievance form requires that the complaining party “explain in detail why you think this attorney has done something improper or has failed to do something which should have been done.” The CDC grievance form is comprehensive in its request for copies of the retainer agreement, proof of payment, correspondence with the responding attorney, and any documents associated with the case. The complaining witness is also advised that a copy of the grievance will be forwarded to the attorney named in the grievance.

When an Original Petition is filed in lieu of the CDC grievance form, only “fair notice” is provided to the responding attorney being accused of disciplinary rule violations.<sup>8</sup>An attorney’s initial response to a the CDC should address each factual allegation raised in the Complaint. The responding attorney has the opportunity to dispel claims of malfeasance through examination of the allegations of the complaining party. The *de minimis* requirement of fair notice pleading is largely insufficient and lacking in comparison to the requirements of the CDC grievance form. The responding attorney in a disciplinary proceeding is at a disadvantage if asked to respond to the general allegations from the lawsuit they are currently fighting in a civil court. The same allegations that can quote statutory language or case law along with a sprinkling of facts and be deemed sufficient to provide notice of the claim.

## B. (CDC perspective)

Submitting live pleadings from a related legal malpractice or civil barratry lawsuit is allowed. It is doubtful that the CDC prefers a copy of a filed lawsuit to its own grievance form. Otherwise, why did the CDC go through the process of providing a grievance form for public use to report alleged attorney misconduct? All grievances are initially assigned to a CDC Classification Attorney. The classification attorney must examine an Original Petition with the same level of scrutiny as that applied to a grievance form. Were just the factual allegations from an Original Petition removed and submitted within a grievance form, it is doubtful that this type of “fair notice” of claim pleading would suffice to factually support purported allegations. In a perfect world, fair notice pleading, without more, would be insufficient and the Original Petition would be deemed an Inquiry and subject to being dismissed.<sup>9</sup> Original Petitions are not always deemed an Inquiry in this context. One possible reason is that the examination of alleged attorney misconduct is complicated by a grievance in the form of an Original Petition because of presumptions that attach to pleadings filed in a district court or county court.

A possible explanation for why otherwise insufficient factual claims in the grievance process are deemed Complaints is the presumption created by section 10.001 of the Civil Practice

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<sup>6</sup> Texas Rule of Civil Procedure 21(a).

<sup>7</sup> *Id.*

<sup>8</sup> Texas Rule of Civil Procedure 47(a) – An original pleading which sets forth a claim for relief shall contain “a short statement of the cause of action sufficient to give fair notice of the claim involved.”

<sup>9</sup> Texas Rule of Disciplinary Procedure 1.06(S) - “Inquiry” means any written matter concerning attorney conduct received by the Office of the Chief Disciplinary Counsel that, even if true, does not allege Professional Misconduct or Disability.

and Remedies Code.<sup>10</sup> Under the heading of *Signing of Pleadings and Motions*, the statute provides that:

*“The signing of a pleading or motion as required by the Texas Rules of Civil Procedure constitutes a certificate by the signatory that to the signatory’s best knowledge, information, and belief, formed after reasonable inquiry:*

*(1) the pleading or motion is not being presented for any improper purpose, including to harass or to cause unnecessary delay or needless increase in the cost of litigation;*

*(2) each claim, defense, or other legal contention in the pleading or motion is warranted by existing law or by a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;*

*(3) each allegation or other factual contention in the pleading or motion has evidentiary support or, for a specifically identified allegation or factual contention, is likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and*

*(4) each denial in the pleading or motion of a factual contention is warranted on the evidence or, for a specifically identified denial, is reasonably based on a lack of information or belief.”<sup>11</sup>*

Section 10.001 provides that the signing of a pleading certifies by the plaintiff’s legal malpractice attorney upon information and belief that each allegation in the Original Petition contains evidentiary support.<sup>12</sup> Both a presumption of investigation and the existence of evidentiary support attaches to an Original Petition when an attorney signs or certifies the document. In light of these presumptions, every notice pleading filed in lieu of the CDC grievance form could be upgraded to a Complaint. If not, it calls into question the due diligence of the attorney certifying the Original Pleadings with the Court. On its face, this serves as a possible explanation as to why an Original Petition that appears to lack sufficient factual allegations would be upgraded to a Complaint rather than being deemed an Inquiry and dismissed.<sup>13</sup>

When the CDC classifies an Original Petition filed in lieu of a CDC grievance form as an Inquiry, written notice of the Inquiry designation is mailed to both the responding attorney and the complaining party.<sup>14</sup> The CDC Inquiry notice letter states in part that after reviewing all of the facts

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<sup>10</sup> Texas CivilPractices&RemediesCode 10.001 – Signing of Pleadings and Motions.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> What is just cause? Rule 1.06 (u) of the Texas Rules of Disciplinary Procedure defines just cause as such cause as is found to exist upon a reasonable inquiry that would induce a reasonably intelligent and prudent person to believe that an attorney either has committed an act of professional misconduct requiring that a sanction be imposed or suffers from a disability that requires either suspension or probation. Thus by definition just cause has three requirements, (1) the CDC should conduct a reasonable inquiry; (2) the CDC should attempt to apply the objective standard of a reasonably intelligent and prudent person and (3) The CDC should conclude that a sanction is required. By implication the rule indicates that not all acts of professional conduct require a sanction.

<sup>14</sup> Texas Rule of Disciplinary Procedure 2.10 –If the Grievance is determined to constitute an Inquiry, the Chief Disciplinary Counsel shall notify the Complainant and Respondent of the dismissal. The Complainant may, within

presented and doing its own analysis, the CDC found that there was not sufficient evidence to support the allegations raised in the Original Petition. The implication of the CDC dismissing the grievance is that the Original Petition (and lawsuit) lacks sufficient facts to show misconduct on the part of the attorney. Though a battle won for the responding attorney, classification of the grievance as an Inquiry is not a final resolution of the grievance.

An Inquiry designation by the CDC classification attorney does not have a *res judicata* effect to preclude any underlying civil claims. The complaining party has the option to appeal within thirty days the Inquiry determination of the CDC to the Board of Disciplinary Appeals (“BODA”).<sup>15</sup> BODA’s affirmation of a CDC Inquiry determination is still not final. The complaining party may then, within 20 days of BODA’s affirmation of Inquiry, file an amended grievance.<sup>16</sup> This is a “one time only” proposition that will continue the grievance process only if the complaining party is able to provide “new or additional evidence” not previously proffered to the CDC.<sup>17</sup> Failure to provide new evidence will conclude the grievance process. A CDC decision that the amended grievance also constitutes an Inquiry can be appealed to BODA. If BODA reverses the CDC’s decision, the matter is deemed a Complaint and a just cause determination is initiated. BODA’s decision to affirm an amended grievance filing as an Inquiry is final and not subject to amendment or appeal.

From the vantage point of the CDC, rather than take a position creating the presumption that the filed Original Petition does not meet the requirements of section 10.001 of the Civil Practice and Remedies Code, maybe the preferable course of action is to just designate the Original Petition as a Complaint and move forward with the just cause determination.<sup>18</sup> The CDC investigation will develop the allegations in the Original Petition during its just cause determination process.<sup>19</sup> This approach would be inherently biased against the responding attorney.

The civil litigation and grievance process are separate and distinct proceedings. Legal representation during the just cause determination phase will prevent premature or unnecessary disclosures that could cause unnecessary inquiry into additional rule violations. A responding attorney in receipt of a grievance Complaint must address every allegation raised in the Complaint within thirty days of receipt, from the CDC, even if the Complaint is the Original Petition from a lawsuit the responding attorney is presently defending against.<sup>20</sup>

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thirty days from notification of the dismissal, appeal the determination to the Board of Disciplinary Appeals. If the Board of Disciplinary Appeals affirms the classification as an Inquiry, the Complainant will be so notified and may within twenty days amend the Grievance one time only by providing new or additional evidence.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> CDC investigators are not married to the facts alleged in the Original Petition. The CDC investigator may (or may not) ask the complaining party for additional information supporting the allegations in the Original Petition.

<sup>19</sup> The CDC employs investigators to assist its attorneys in determining whether a violation of the disciplinary rules occurred. The scope of experience within the ranks of the CDC investigators includes, but is not limited to former military, military police, law enforcement, Secret Service, SEC investigators, and attorneys.

<sup>20</sup> Texas Rule of Disciplinary Procedure 2.10 – “If the Grievance is determined to constitute a Complaint, the Respondent shall be provided a copy the Complaint with Notice to respond in writing, to the allegations of the Complaint. The notice shall advise the Respondent that the Chief Disciplinary Counsel may provide appropriate information, including the Respondent’s response, to law enforcement agencies as permitted by Rule 6.08.

This is not an instance where a responding attorney can rely upon the Texas Rules of Civil Procedure and generally deny the allegations in the Complaint.<sup>21</sup> The attorney who fails to respond to the CDC's inquiry runs afoul of Texas Disciplinary Rule of Professional Conduct 8.04(a)(8).<sup>22</sup> Rule 8.04(a)(8) states that a lawyer shall not fail to furnish to the Chief Disciplinary Counsel's office a timely response or other information as required by the Texas Rules of Disciplinary Procedure. The rule does allow for a responding attorney to assert a privilege or other legal ground for failing to respond. In this particular instance, arguably, a responding attorney could assert that they are not responding because there is an ongoing criminal matter or because there is an ongoing civil matter. Whether this in itself will stop a disciplinary proceeding is doubtful when the grievance process is subject to mandatory statutory deadlines.<sup>23</sup>

Texas Rule of Disciplinary Procedure 15.02, titled "Effect of Related Litigation" is unequivocal that the processing of a Grievance, Complaint, Disciplinary Proceeding or Disciplinary Action is not, except for good cause, to be delayed or abated because of substantial similarity in material allegations raised in pending civil or criminal litigation.<sup>24</sup> Essentially at this point, the grievance has been deemed a Complaint and a just cause determination is being investigated. In answering the grievance Complaint that is the opponent's Original Petition, the responding attorney must either present all of their evidence and defenses to the civil lawsuit within thirty days or present limited to no evidence and risk a just cause finding by the CDC. If the latter, a lawsuit by the Commission for Lawyer Discipline would be filed and the responding attorney is now faced with additional legal fees. The benefit of responding and including facts that might otherwise have been disclosed at a later date is that you may be able to persuade a CDC investigator that the complaining party's claims are meritless. Whether the grievance proceedings are dismissed or not, the information submitted to the CDC by the responding attorney is a discovery windfall for the Plaintiff early on in the underlying legal malpractice or civil barratry litigation.

When the CDC investigates the responding attorney, it turns over information received from the responding attorney to the complaining party. This discovery is both beneficial to the civil lawsuit and done at no cost to plaintiff/complaining party. In what other practice area of law is it possible to make an allegation against the opposing party and then have a third party agency take over the investigation and return to you a copy of every document produced by the opposing party in response to the allegations? This all occurs under the threat of sanction if the responding

<sup>21</sup> Texas Rule of Civil Procedure 85 – Stating that the original answer may consist of a "general denial."

<sup>22</sup> Texas Disciplinary Rule of Professional Conduct 8.04(8) – a lawyer shall not fail to timely furnish to the Chief Disciplinary Counsel's office or a district grievance committee a response or other information as required by the Texas Rules of Disciplinary Procedure, unless he or she in good faith timely asserts a privilege or other legal ground for failure to do so.

<sup>23</sup> Texas Rule of Disciplinary Procedure 15.05 – Effect of Time Limitations: The time periods provided in Rules 2.10 (*Classification of Inquiries and Complaints*), 2.12 (*Investigation and Determination of Just Cause*), 2.15 (*Election*), 2.17C (*Default*), 2.17E (*Limited Discovery*), 2.17P (*Decision*), 2.25 (*No Supersedeas*), 3.02 (*Assignment of Judge*), 3.04 (*Answer of the Respondent*), 7.11 (*Judicial Review*), 9.02 (*Notice to the Respondent*), 9.03 (*Discipline to be Imposed*), 10.02 (*Response of Chief Disciplinary Counsel*), 11.01 (*Eligibility and Venue*), 11.08 (*Repetitioning*) and 12.06(d) (*Reinstatement After Disability Suspension*) are mandatory. All other time periods herein provided are directory only and the failure to comply with them does not result in the invalidation of an act or event by reason of the noncompliance within those time limits.

<sup>24</sup> Texas Rule of Disciplinary Procedure 15.02 – The processing of a Grievance, Complaint, Disciplinary Proceeding, or Disciplinary Action is not, except for good cause, to be delayed or abated because of a substantial similarity to the material allegations in pending civil or criminal litigation.

attorney fails to respond to the allegations raised in the Original Petition. Responding attorneys that have sought a stay, attempted to abate, or attempted to obtain some type of injunctive relief to stop the grievance proceedings altogether, rarely obtain the relief sought.<sup>25</sup>

### C. (Confidentiality)

Texas Rules of Disciplinary Procedure 2.16 and 6.08 are the procedural rules regarding confidentiality during the grievance process. These rules outline the scope of confidentiality in disciplinary proceedings before BODA, as well as, communications to non-parties by the CDC, the Commission for Lawyer Discipline and members of the Evidentiary Panels. In general, grievance proceedings are confidential, but there are limited exceptions to this rule. The first exception is that the responding attorney can waive confidentiality.<sup>26</sup> The second is that if the attorney receives a sanction of a public reprimand or harsher than the Evidentiary Panel's final judgment becomes a public record.<sup>27</sup> After final appeal, the CDC shall upon request disclose all documents, statements and other information that came from the Evidentiary Panel.<sup>28</sup> The third exception is that the record and appeal to BODA of an Evidentiary Panel's judgment that assesses anything more than a private reprimand is available for review.<sup>29</sup> The final exception is that facts and evidence that are otherwise discoverable elsewhere do not become confidential simply by introduction during the grievance process.<sup>30</sup>

As previously stated, the grievance process affords that the complaining party receive a copy of every document produced by the responding attorney. This information could include a copy of the response to the grievance complaint by the responding attorney, any exhibits attached to the response, and copies of correspondence between the responding attorney and the CDC. Information produced by the responding attorney is not limited from disclosure by the complaining party. The complaining party is not limited in disclosing information or discovery produced during the grievance proceedings. The Texas Supreme Court specifically removed the complaining party from the list of individuals and organizations subject to the confidentiality provisions of the Texas Rules of Disciplinary Procedure.<sup>31</sup> There is nothing to stop the complaining party from posting grievance related document production on their social media page, from uploading deposition transcripts and/or video onto the internet, or from using information gained in the disciplinary proceedings in their prosecution of the barratry claim.

Furthermore, during the just cause determination phase, if the responding attorney wanted to seal responsive documents, where does jurisdiction lie? At this point, the responding attorney has not elected to have the matter heard by either a district court or evidentiary panel and the CDC

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<sup>25</sup> *In Re State Bar of Texas*, 960 S.W.2d 651 (Tex. 1997) (court stated that a trial court has no jurisdiction to enjoin attorney disciplinary proceedings); *Favaloro v. Commission for Lawyer Discipline*, 13 S.W.3d 831, 837 (Tex. App.—Dallas 2000, no pet.) (A district court does not have jurisdiction to interfere with the grievance procedures authorized by the State Bar Act.)

<sup>26</sup> Texas Rule of Disciplinary Procedure 2.16(A)(1).

<sup>27</sup> Texas Rule of Disciplinary Procedure 2.16(A)(2)(a).

<sup>28</sup> Texas Rule of Disciplinary Procedure 2.16(A)(2)(b).

<sup>29</sup> Texas Rule of Disciplinary Procedure 2.16(A)(3).

<sup>30</sup> Texas Rule of Disciplinary Procedure 2.16(A)(4).

<sup>31</sup> Texas Rule of Disciplinary Procedure 2.16(A).

has no authority to limit the complaining party's use of otherwise confidential information gained during the grievance process.

### III. BARRATRY

There exists an infinite multitude of jokes and platitudes that present personal injury attorneys as unsympathetic, nefarious and litigious figures. Barratry lawsuits often involve personal injury attorneys. This may be viewed, rather tongue-in-cheek, as the group receiving its "just deserts." However, every practice area and insurer of solo practitioner and small law firms should take note of the *business of barratry* affecting the personal injury practice area. Law firms are now advertising that they sue attorneys on behalf of former clients. The public is being told that they can recover paid attorney fees if they were solicited as a client. All they have to do is *just come in for a free consultation and we may be able to recover money for you!* Even if little evidence is available that the client was solicited by the former attorney, that information could be obtained through a CDC investigation. With the emotion involved in responding to a grievance, even the most skilled litigators can misstate or incorrectly phrase what occurred and find themselves admitting to or opening up inquiry into a disciplinary rule violation.

The framework of the barratry lawsuit is the perfect example of how the grievance process is used in conjunction with a civil lawsuit. The notion of barratry has evolved beyond the common term of "ambulance chasing." Attorneys or their "runners" traveling to accident scenes to promote a law firm's services and seek out new clients does still occur in limited instances. Modern day barratry has evolved, along with the applicable statutes, into a cottage industry of non-attorney intermediaries who seek out clients for law firms and law firms for its clients.<sup>32</sup>

In response to this growth of intermediaries, the barratry statutes have evolved to include the attorney and non-attorney professional who, "with intent to obtain an economic benefit . . . solicits employment, either in person or by telephone, for himself or for another."<sup>33</sup> A professional commits barratry if that individual knowingly accepts employment within the scope of the person's license, registration, or certification that results from the solicitation of employment. The barratry statute provides penalties for the party who pays another to solicit employment, as well as the party who accepts or agrees to accept money or anything of value to solicit employment.<sup>34</sup> Criminally, an offense under the barratry statute is a felony of the third degree.<sup>35</sup> Such a severe penalty is intended to have a "chilling effect" on the commission of barratry by both attorney and non-attorney.

In the disciplinary context, barratry is categorized as a *Serious Crime*.<sup>36</sup> Because proof of barratry requires proof of *knowledge* or *intent* as an essential element, the offense of barratry is

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<sup>32</sup> V.T.C.A., Gov't Code §82.0651 – Civil Liability for Prohibited Barratry; V.T.C.A., Penal Code §38.12 – Barratry and Solicitation of Professional Employment; and V.T.C.A., Gov't T.2, Subt. G App. A, Art. 10, §9, Rule 7.03 – Prohibited Solicitations and Payments

<sup>33</sup> Texas Penal Code 38.12(a)

<sup>34</sup> Texas Penal Code 38.12(a)(4) and (a)(6).

<sup>35</sup> Texas Penal Code 38.12(a)(f) and (a)(h).

<sup>36</sup> Texas Rule of Disciplinary Procedure 1.06(AA) – "Serious Crime" means barratry; any felony involving moral turpitude; any misdemeanor involving theft, embezzlement, or fraudulent or reckless misappropriation of money or other property; or any attempt, conspiracy, or solicitation of another to commit any of the foregoing crimes.

also deemed an *Intentional Crime*.<sup>37</sup> The *Intentional Crime* designation allows the CDC to initiate a Disciplinary Action against an attorney by filing a petition before the Board of Disciplinary Appeals (“BODA”) alleging the “adjudication of guilt (or probation without an adjudication of guilt) of an *Intentional Crime*.” The petition will state that the attorney found guilty of barratry is the same named in the pending matter and will seek the appropriate discipline.<sup>38</sup> When the conviction of barratry becomes final, or the attorney accepts probation for barratry, the attorney is disbarred unless BODA suspends his or her license to practice law.<sup>39</sup> An attorney whose criminal sentence is fully probated, or one who receives probation through deferred adjudication, will be suspended from the practice of law during the term of the probation.<sup>40</sup> The attorney’s return to the practice of law will be conditioned upon the attorney’s satisfactory completion of the terms of probation.<sup>41</sup> “If the probation is revoked, the attorney shall be disbarred.”<sup>42</sup>

Considering all of the aforementioned, and how much is at stake professionally and personally for the individual attorney and other professionals, barratry continues to persist. The enforcement of barratry violations amongst attorneys in Texas has been primarily relegated to the CDC, on behalf of its client the Commission for Lawyer Discipline, and local government prosecutors. However, the landscape of how the legal profession polices itself is changing dramatically with the increased prosecution of private civil claims of barratry. Even in instances where the attorney recovered large sums of money on behalf of the client, clients may feel led to bring a barratry claim due to their own social conscience and/or the lucrative temptation that a win may lead to recovery of attorneys’ fees.

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<sup>37</sup> Texas Rule of Disciplinary Procedure 1.06(T) – “Intentional Crime” means (1) any Serious Crime that requires proof of knowledge or intent as an essential element or (2) any crime involving misapplication of money or other property held as a fiduciary.

<sup>38</sup> Texas Rule of Disciplinary Procedure 8.03 – a Disciplinary Action under this part must be initiated by the filing of a petition with the Board of Disciplinary Appeals. The petition must allege the adjudication of guilt (or probation without an adjudication of guilt) of an Intentional Crime; allege that the Respondent is the same person as the party adjudicated guilty or who received probation with or without an adjudication of guilt for such Intentional Crime; and seek the appropriate discipline.

<sup>39</sup> Texas Rule of Disciplinary Procedure 8.05 – When an attorney has been convicted of an Intentional Crime, and that conviction has become final, or the attorney has accepted probation with or without an adjudication of guilt for an Intentional Crime, the attorney shall be disbarred unless the Board of Disciplinary Appeals, under Rule 8.06, suspends his or her license to practice law. If the attorney’s license to practice law has been suspended during the appeal of the criminal conviction, the Chief Disciplinary Counsel shall file a motion for final judgment of disbarment with the Board of Disciplinary Appeals. If the motion is supported by affidavits or certified copies of court documents showing that the conviction has become final, the motion shall be granted without hearing, unless within ten days following the service of the motion pursuant to Rule 21a of the Texas Rules of Civil Procedure, upon the attorney so convicted or his or her attorney of record, the attorney so convicted files a verified denial contesting the finality of the judgment, in which event the Board of Disciplinary Appeals will immediately conduct a hearing to determine the issue. If no Disciplinary Action is pending at the time the conviction becomes final, disbarment shall be initiated by filing a Disciplinary Action.

<sup>40</sup> Texas Rule of Disciplinary Procedure 8.06 – If an attorney’s sentence upon conviction of a Serious Crime is fully probated, or if an attorney receives probation through deferred adjudication in connection with a Serious Crime, the attorney’s license to practice law shall be suspended during the term of probation. If an attorney is suspended during the term of probation, the suspension shall be conditioned upon the attorney’s satisfactorily completing the terms of probation. If the probation is revoked, the attorney shall be disbarred. An early termination of probation does not result in reinstatement until the entire probationary period, as originally assessed, has expired.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

Government Code §82.065 allow client's to void a contract for legal services.<sup>43</sup> Government Code §82.0651 provides that a client who is successful in voiding a contract for legal services "shall" recover from any person who committed barratry:

- (1) all fees and expenses paid to that person under the contract;
- (2) the balance of any fees and expenses paid to any other person under the contract, after deducting fees and expenses awarded based on a quantum meruit theory as provided by Section 82.065(c);
- (3) actual damages caused by the prohibited conduct;
- (4) a penalty in the amount of \$10,000; and
- (5) reasonable and necessary attorney's fees.

The Code Construction Act provides that use of the term "shall" imposes a duty.<sup>44</sup> It is this very use of the term "shall" that spurs the growth of litigation in the area of barratry lawsuits filed by former clients. Disgorgement of attorney's fees would be welcomed by clients in most areas of legal practice, but especially in the personal injury context due to the nature of the contingent fee arrangement. A client could stand to regain from 33% to 45% of the original settlement amount or judgment award paid to its attorney upon a finding that barratry occurred.

#### **A. Business of barratry**

As an attorney, an allegation of barratry is an affront to one's character, professionalism, and practice of the law. It places the attorney's professional and personal life in jeopardy. By no means is this an indictment against barratry or legal malpractice claims. There is no denying that barratry and legal malpractice do occur and are a nuisance to clients and fellow attorneys. This is solely are view of the issue of barratry and the possible evolution of the barratry practitioner.

Similar to other claims, first notice of the potential barratry claim may arrive in the form of a demand letter. The demand amount can range from a \$10,000 statutory penalty award to an amount meant to encompass every dollar previously paid for attorneys' fees. It could include case expenses, actual damages, and the reasonable and necessary attorneys' fees for the former client's new legal counsel. At this point, outrage would be expected at the thought that a client, for whom the attorney may have secured a favorable outcome, would now claim that the attorney-client relationship was formed in violation of the applicable law.

The business of barratry involves the interplay of Section 38.12(a) and/or (b) of the Penal Code, Rule 7.03 of the Texas Disciplinary Rules of Professional Conduct and Section 82.065(1)

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<sup>43</sup> V.T.C.A., Gov't Code §82.0651 – (a) a contingent fee contract for legal services must be in writing and signed by the attorney and client. (b) Any contract for legal services is voidable by the client if it is procured as a result of conduct violating Section 38.12(a) or (b), Penal Code, or Rule 7.03 of the Texas Disciplinary Rules of Professional Conduct of the State Bar of Texas, regarding barratry by attorneys or other persons.

<sup>44</sup> TEX. GOV'T CODE ANN. § 311.016(2) (West 2005).

The Civil Liability Prohibited Barratry statute.<sup>45</sup> The interplay of the criminal, civil and disciplinary proceedings can be used to put an attorney responding to a grievance and/or barratry claim at a significant disadvantage. Beyond the obvious inconvenience of having to defend multiple civil and/or criminal proceedings, there is the added difficulty of the mandates of the Texas Rules of Disciplinary Procedure.<sup>46</sup> An attorney sued for civil barratry can file a general denial to the Plaintiff's Original Petition without disclosing information.<sup>47</sup> An attorney charged with violation of the penal code has the option to refrain from testifying. These options do not extend to grievance proceedings. A CDC investigation cannot be limited by orders from the civil or criminal court.

The grievance filed along with the barratry lawsuit occurs, in part, because of the statutory recovery limits in barratry. Regardless of whether any wrongdoing occurred, settling a barratry claim rather than pursuing litigation is often the better financial decision. One reason could be that the attorney may or may not have legal malpractice insurance. The out-of-pocket costs associated with the litigation may far exceed the amount demanded from the former client. Another reason could be that the civil barratry statute allows recovery of up to \$10,000 per wrongfully solicited party. For example, the high volume personal injury practice area most often associated with barratry is the non-commercial motor vehicle accident claim. The current minimum automobile insurance liability limits are \$30,000 for each injured person, up to a total of \$60,000 per accident, and \$25,000 for property damage per accident. The attorney recovery, including fees, court costs and expenses, would be under \$25,000 in the majority of cases involving minimum liability insurance. For that reason, the personal injury attorney faced with a barratry claim may settle the claim because, even with the disgorgement of fees, the amount at issue is less than the attorney's legal malpractice insurance deductible and far less than the costs anticipated in defending the matter. As a rule, early resolution should be the preferable course of action for the attorney that has any doubt surrounding whether he or she can walk away unscathed should the law firm's practices and procedures in acquiring new clients undergo CDC scrutiny.

Often, the *pro se* responding attorney occurs as a matter of personal choice or necessity when there is limited coverage or no coverage for grievances through a legal malpractice insurance carrier. A responding attorney should not proceed *pro se* against the CDC. The just cause determination process develops at a monetary and emotional cost to the responding attorney. As with any other litigation, a party to a lawsuit should not serve as their own legal counsel. Think in terms of the quote attributed to Abraham Lincoln, "He who represents himself has a fool for a client." Grievance proceedings are an emotional process for the responding attorney. To think otherwise is imprudent. The complaining party is making a claim that impugns the character and professionalism of the responding attorney. The responding attorneys' very livelihood may be at stake. Competent legal counsel that is familiar with both legal malpractice litigation and the grievance process is necessary.

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<sup>45</sup> V.T.C.A., Tex. Gov't Code §82.0651 – Civil Liability for Prohibited Barratry; V.T.C.A., Penal Code §38.12 – Barratry and Solicitation of Professional Employment; and V.T.C.A., Gov.t T.2, Subt. G App. A, Art. 10, §9, Rule 7.03 – Prohibited Solicitations and Payments

<sup>46</sup> Texas Rule of Disciplinary Procedure 1.01, *et al.*

<sup>47</sup> Texas Rule of Civil Procedure 92. General Denial – "A general denial of matters pleaded by the adverse party which are not required to be denied under oath, shall be sufficient to put the same in issue."



## **BACK TO BUSINESS: A PRACTICAL GUIDE ON HOW TO REINSTATE INVOLUNTARILY TERMINATED & FORFEITED BUSINESS ENTITIES IN TEXAS**

JONATHAN R. EVERHART\*

### **Abstract**

*Thousands of business entities in Texas do not know that the legal status of their entity has been involuntarily terminated or forfeited by the Secretary of State or Comptroller of Public Accounts. Businesses usually become aware of this issue during a critical transaction, such as filing a lawsuit or the sale of the business. The impact of having an entity's status involuntarily terminated or forfeited includes:*

- *The entity does not have the right to sue or assert a counter claim.*
- *The directors, officers, and owners are personally liable for the obligations of the entity during the time the entity's status is forfeited, even after reinstatement of the entity.*
- *The lapse in the existence of the entity can cause significant issues when attempting to sell the business.*

*This article provides a practical guide for attorneys on how to reinstate involuntarily terminated and forfeited business entities in Texas. First, it details how a business entity can be involuntarily terminated and forfeited under the Texas Business Organizations Code (BOC) and the Texas Tax Code (Tax Code). Next, the effects of involuntary termination and forfeiture are explained through statutory mandates and court rulings. Finally, the statutory procedures for reinstatement are discussed. This article focuses solely on the involuntary termination and forfeiture of corporations, limited liability companies, and non-profit corporations because they are the predominant forms of business entities in Texas.*

### **INTRODUCTION**

Thousands of business entities in Texas do not know that the legal status of their entity has been involuntarily terminated or forfeited by the Secretary of State or Comptroller of Public Accounts. Businesses usually become aware of this issue during a critical transaction, such as filing a lawsuit or the sale of the business. As a result, the business and its attorney are faced with the challenge of properly reinstating the entity's legal status. In some cases, reinstatement still leaves the business and its owners stripped of key legal privileges.

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In Texas, one of the predominant ways business entities are terminated is for failure to submit their franchise tax report. Each taxable entity formed in Texas or doing business in Texas must file and pay franchise taxes. Failure to do so results in the Comptroller of Public Accounts declaring the entity's status as involuntarily terminated and the Secretary of State subsequently affirming the entity's status as forfeited. The impact of having an entity's status involuntarily terminated or forfeited includes:

- The entity does not have the right to sue or assert a counter claim.
- The directors, officers, and owners are personally liable for the obligations of the entity during the time the entity's status is forfeited, even after reinstatement of the entity.
- The lapse in the existence of the entity can cause significant issues when attempting to sell the business.

This article provides a practical guide for attorneys on how to reinstate involuntarily terminated and forfeited business entities in Texas. First, it details how a business entity can be involuntarily terminated and forfeited under the Texas Business Organizations Code (BOC) and the Texas Tax Code (Tax Code). Next, the effects of involuntary termination and forfeiture are explained through statutory mandates and court rulings. Finally, the statutory procedures for reinstatement are discussed. This article focuses solely on the involuntary termination and forfeiture of corporations, limited liability companies, and non-profit corporations because they are the predominant forms of business entities in Texas.

## **INVOLUNTARY TERMINATION & FORFEITURE**

### **Involuntary Termination Under Chapter 11 of the BOC**

The Secretary of State may involuntarily terminate the existence of a filing entity if the secretary finds that:

- (1) the entity has failed to, and, before the 91st day after the date notice was mailed has not corrected the entity's failure to:
  - (A) file a report within the period required by law or pay a fee or penalty prescribed by law when due and payable; or
  - (B) maintain a registered agent or registered office in the state as required by law; or
- (2) the entity has failed to, and, before the 16th day after the date notice was mailed has not corrected the entity's failure to, pay a fee required in connection with the filing of its certificate of formation, or payment of the fee was dishonored when presented by the state for payment.<sup>1</sup>

### **Forfeiture Under Chapter 171 of the Tax Code**

Each taxable entity formed in Texas or doing business in Texas must file and pay franchise taxes. These entities include: corporations, limited liability companies (including series LLCs), banks, state limited banking associations, savings and loan associations, partnerships (general, limited and limited liability), trusts, professional associations, business associations, joint ventures, and other legal entities.<sup>2</sup> Section 11.251 of the BOC does not specify failure to pay franchise taxes as a grounds for involuntary termination under the BOC, however § 171.251 and § 171.2515 of the Tax Code expressly grant the Texas Comptroller the right to do so. Under § 171.251 the Comptroller shall forfeit the corporate privileges of a corporation on which the franchise tax is imposed if the corporation: (1) does not file, in accordance with this chapter and

<sup>1</sup> TEX. BUS. ORGS. CODE ANN. § 11.251(b) (West 2015).

<sup>2</sup> TEX. TAX CODE ANN. § 171.0002-171.0005 (West 2015).

within 45 days after the date notice of forfeiture is mailed, a report required by this chapter; (2) does not pay, within 45 days after the date notice of forfeiture is mailed, a tax imposed by this chapter or does not pay, within those 45 days, a penalty imposed by this chapter relating to that tax; or (3) does not permit the Comptroller to examine under § 171.211 of the code the corporation's records.<sup>3</sup>

Section 171.2515(a) additionally provides that the Comptroller may, for the same reasons and using the same procedures the Comptroller uses in relation to the forfeiture of the corporate privileges of a corporation, forfeit the right of a taxable entity to transact business in the state.<sup>4</sup> Further, the provisions of this subchapter, including § 171.255, that apply to the forfeiture of corporate privileges apply to the forfeiture of a taxable entity's right to transact business in the state.<sup>5</sup>

After the 120th day after the date that the corporate privileges of a corporation are forfeited, the Comptroller may certify the name of the corporation to the attorney general and the Secretary of State.<sup>6</sup> Subsequently, the Secretary of State may forfeit the charter, certificate, or registration of a taxable entity if: (1) the secretary receives the Comptroller's certification under § 171.302 and (2) the taxable entity does not revive its forfeited privileges within 120 days after the date that the privileges were forfeited.<sup>7</sup> Essential for entities facing this circumstance to note is that the forfeiture by the Secretary of State of a corporation's charter or certificate of authority under this chapter is effected without a judicial proceeding.<sup>8</sup>

### **Forfeiture Under Chapter 22 of the BOC**

Chapter 22 of the BOC outlines the forfeiture of a nonprofit corporation for failure to file its periodic report. A domestic or foreign corporation that fails to file a report under § 22.357 and § 22.359 when the report is due forfeits the corporation's right to conduct affairs in the state.<sup>9</sup> The forfeiture takes effect, without judicial action, when the Secretary of State enters on the record of the corporation kept in the office of the Secretary of State: (1) the words *right to conduct affairs forfeited* and (2) the date of forfeiture.<sup>10</sup>

## **EFFECTS OF INVOLUNTARY TERMINATION & FORFEITURE**

### **Effects of an Involuntary Termination Under Chapter 11 of the BOC**

Under § 11.001, a terminated entity means a domestic entity the existence of which has been terminated in a manner authorized or required by the code, unless the entity has been reinstated in the manner provided by the code; or forfeited pursuant to the Tax Code, unless the forfeiture has been set aside.<sup>11</sup> Once a business entity has been terminated, the Secretary of State issues a Certificate of Termination, in accordance with the requirements of § 11.252.

<sup>3</sup> TEX. TAX CODE ANN. § 171.251 (West 2015).

<sup>4</sup> TEX. TAX CODE ANN. § 171.2515(a) (West 2015).

<sup>5</sup> TEX. TAX CODE ANN. § 171.2515(b) (West 2015).

<sup>6</sup> TEX. TAX CODE ANN. § 171.302 (West 2015).

<sup>7</sup> TEX. TAX CODE ANN. § 171.309 (West 2015).

<sup>8</sup> TEX. TAX CODE ANN. § 171.310 (West 2015).

<sup>9</sup> TEX. BUS. ORGS. CODE ANN. § 22.360 (a) (West 2015).

<sup>10</sup> TEX. BUS. ORGS. CODE ANN. § 22.360(b) (West 2015).

<sup>11</sup> TEX. BUS. ORGS. CODE ANN. § 11.001 (West 2015).

A terminated filing entity may not continue its existence for the purpose of continuing the business or affairs for which the terminated filing entity was formed unless the terminated filing entity is reinstated.<sup>12</sup> The terminated filing entity continues in existence until the third anniversary of the effective date of the entity's termination only for purposes of: (1) prosecuting or defending in the terminated filing entity's name an action or proceeding brought by or against the terminated entity; (2) permitting the survival of an existing claim by or against the terminated filing entity; (3) holding title to and liquidating property that remained with the terminated filing entity at the time of termination or property that is collected by the terminated filing entity after termination; (4) applying or distributing property, or its proceeds; and (5) settling affairs not completed before termination.<sup>13</sup>

A terminated filing entity is liable only for an existing legal claim.<sup>14</sup> An existing legal claim means a claim that existed before the entity's termination and is not barred by limitations or a contractual obligation incurred after termination.<sup>15</sup> If an action on an existing claim by or against a terminated filing entity has been brought before the expiration of the three-year period after the date of the entity's termination and the claim was not extinguished under § 11.359, the terminated filing entity continues to survive for purposes of the action until all judgments, orders, and decrees have been fully executed and the application or distribution of any property of the terminated filing entity until the property has been applied or distributed.<sup>16</sup>

Courts in several cases have applied the rules in BOC § 11.356 regarding the corporate existence and viability of claims by and against corporations whose charters have been forfeited under the Tax Code. In *Endsley Elec., Inc. v. Altech, Inc.*, a corporation whose charter was forfeited under the Tax Code in January 2011 continued to exist under § 11.356 of the BOC for purposes of defending suit brought against it in April 2010.<sup>17</sup> Similarly, in *First Trust Corp. TTEE FBO v. Edwards*, a forfeited corporation continued to exist for three years for limited purposes under the statute and its assets remained vested in the corporation so that the corporate form could not be disregarded based only on forfeiture of the corporate charter.<sup>18</sup>

The court in *Landrum v. Thunderbird Speedway* concluded that a corporation could not be held liable on a wrongful death claim based on an accident occurring sixteen months after tax forfeiture of the corporation because the claim was not an existing claim that could be asserted against a dissolved corporation.<sup>19</sup> *Emmett Props, Inc. v. Halliburton Energy Servs., Inc.*, followed and demonstrated that a corporation could not sue on a claim that existed before forfeiture and was not asserted within three years after forfeiture because the claim was barred.<sup>20</sup>

### Effects of a Forfeiture Under Chapter 171 of the Tax Code

The Comptroller may, for the same reasons and using the same procedures the Comptroller uses in relation to the forfeiture of the corporate privileges of a corporation, forfeit the right of a

<sup>12</sup> TEX. BUS. ORGS. CODE ANN. § 11.356(b) (West 2015).

<sup>13</sup> TEX. BUS. ORGS. CODE ANN. § 11.356(a) (West 2015).

<sup>14</sup> TEX. BUS. ORGS. CODE ANN. § 11.351 (West 2015).

<sup>15</sup> TEX. BUS. ORGS. CODE ANN. § 11.001 (West 2015).

<sup>16</sup> TEX. BUS. ORGS. CODE ANN. § 11.356(c) (West 2015).

<sup>17</sup> *Endsley Elec., Inc. v. Altech, Inc.*, 378 S.W.3d 15 (Tex.App.—Texarkana 2012, no pet.).

<sup>18</sup> *First Trust Corp. TTEE FBO v. Edwards*, 172 S.W.3d 230 (Tex.App.—Dallas 2005, pet. denied).

<sup>19</sup> *Landrum v. Thunderbird Speedway*, 97 S.W.3d 756 (Tex.App.—Dallas 2003, no pet.).

<sup>20</sup> *Emmett Props, Inc. v. Halliburton Energy Servs., Inc.*, 167 S.W.3d 365 (Tex. App.—Houston [14th Dist.] 2005, pet. denied).

taxable entity to transact business in the state.<sup>21</sup> If the corporate privileges of a corporation are forfeited under the Tax Code, the corporation is denied the right to sue or defend in a court of the state and each director or officer of the corporation is liable for a debt of the corporation.<sup>22</sup> The debt must be created or incurred in the state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived.<sup>23</sup> The liability includes liability for any tax or penalty imposed by the Tax Code on the corporation that becomes due and payable after the date of the forfeiture.<sup>24</sup>

A director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred over the director's objection or without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt.<sup>25</sup> Courts have concluded that a director relying on an exception to liability under this provision has the burden of proof, i.e., that the exceptions are affirmative defenses.<sup>26</sup> It is important to note that the liability here of a director or officer of the corporation is not eliminated by the reinstatement of the charter or certificate and the corporate privileges if a corporation's charter or certificate of authority and its corporate privileges are forfeited and then reinstated.<sup>27</sup> Section 171.255 provides that the personal liability of officers and directors extends back to debts created or incurred after the report, tax, or penalty was due. Some courts have concluded that debts for which directors and officers may have personal liability under § 171.255 do not include tort liability based on negligence.<sup>28</sup>

In a suit against a corporation on a cause of action arising before the forfeiture of the corporate privileges of the corporation, affirmative relief may not be granted to the corporation unless its corporate privileges are reinstated.<sup>29</sup> A forfeiture of corporate privileges deprives a corporation of the capacity to sue but does not make a suit void, and the lack of capacity is waived unless challenged by a verified plea.<sup>30</sup> However, the forfeiture of the corporate privileges of a corporation does not apply to the privilege to defend in a suit to forfeit the corporation's charter or certificate of authority.<sup>31</sup> Traditionally, courts have precluded an entity only from filing suit after forfeiting its right to do business, not to prohibit it from continuing an action filed before its privileges were forfeited.<sup>32</sup>

To illustrate, the court in *In re Am. Heartland Sagebrush § Invs., Inc.* prevented a corporation that had been forfeited under the Tax Code more than ten years earlier from filing

<sup>21</sup> TEX. TAX CODE ANN. § 171.2515 (West 2015).

<sup>22</sup> TEX. TAX CODE ANN. § 171.252 (West 2015).

<sup>23</sup> TEX. TAX CODE ANN. § 171.255(a) (West 2015).

<sup>24</sup> TEX. TAX CODE ANN. § 171.255(a) (West 2015).

<sup>25</sup> TEX. TAX CODE ANN. § 171.255(c) (West 2015).

<sup>26</sup> TEX. TAX CODE ANN. § 171.255(c) (West 2015). See *Priddy v. Rawson*, 282 S.W.3d 588 (Tex.App.–Houston [14th Dist.] 2009, pet. denied); *In re Trammell*, 246 S.W.3d 815 (Tex.App.–Dallas 2008, no pet.); *PACCAR Fin. Corp. v. Potter*, 239 S.W.3d 879 (Tex.App.–Dallas 2007, no pet.); *Surber v. Woy*, No. 02-12-00452-CV, 2014 WL 1704258 (Tex.App.–Fort Worth Apr. 30, 2014, no pet.).

<sup>27</sup> TEX. TAX CODE ANN. § 171.255(d) (West 2015).

<sup>28</sup> *Williams v. Adams*, 74 S.W.3d 437 (Tex.App.–Corpus Christi 2002, pet. denied); *Suntide Sandpit, Inc. v. H & H Sand and Gravel, Inc.*, No. 13-11-00323-0CV, 2012 WL 2929605 (Tex.App.–Corpus Christi July 19, 2012, pet. denied).

<sup>29</sup> TEX. TAX CODE ANN. § 171.253 (West 2015).

<sup>30</sup> *Cognata v. Down Hole Injection, Inc.*, 375 S.W.3d 370, 376 (Tex.App.–Houston [14th Dist.] 2012, pet. denied).

<sup>31</sup> TEX. TAX CODE ANN. § 171.254 (West 2015).

<sup>32</sup> See *Waterway Ranch, LLC v. City of Annetta*, 411 S.W.3d 667 (Tex.App.–Fort Worth 2013, no pet.); *Texas Clinical Labs, Inc. v. Leavitt*, 535 F.3d 397 (5th Cir. 2008).

Chapter 7 bankruptcy because its existence as a dissolved corporation for winding up purposes only continued for three years following its dissolution.<sup>33</sup> In contrast, *In re ABZ Ins. Servs., Inc.*, demonstrated that a corporation that had been forfeited under the Tax Code was eligible for bankruptcy relief under Chapter 7 where the proceeding was filed within three years of dissolution because the BOC provides that a dissolved corporation continues its existence for three years following dissolution for limited purposes of liquidation and distribution of assets.<sup>34</sup>

The denial of the right to sue or defend applies by its plain terms only to the corporation and does not apply to directors and officers; the penalty applicable to an officer or director under the forfeiture provision is personal liability for corporate debts under § 171.255.<sup>35</sup> If a forfeited corporation's capacity to sue is challenged, abatement rather than dismissal is favored, and the corporation is afforded the opportunity to cure the defect by paying the delinquent taxes or requesting that the forfeiture be set aside.<sup>36</sup>

The courts have also established rights for shareholder suits in instances where the corporation's status has been forfeited. The court in *Robinette v. Merrill Lynch, Pierce, Fenner & Smith* concluded that precedent cases established the following principles: (1) forfeiture of a corporation's charter does not prohibit stockholders from obtaining relief from fraudulent and oppressive acts of corporate directors or prevent stockholders from redressing wrongs that injure their right and interest in corporate assets; (2) suit can only be maintained by a stockholder for the benefit of a corporation where the cause of action is based on fraud, ultra vires acts, or negligence of the directors; (3) an incapacitated corporation cannot bring a cause of action that is an ordinary one that accrues to the corporation in the due course of business, and such a suit cannot be maintained for the corporation's benefit by an agent, assignee, or stockholder; (4) when a corporation has been denied the right to use the courts, property the corporation holds in trust for its stockholders is not subject to appropriation by third parties, and suit must be brought by the individual stockholders in their own right; and (5) forfeiture of a corporate charter does not destroy or forfeit the property of the corporation, and the stockholders, who are the beneficial owners of the property, are authorized to prosecute or defend such actions in court as are necessary to protect their property rights.<sup>37</sup>

### **Effects of a Forfeiture Under Chapter 22 of the BOC**

The corporation or a successor or assignee of the corporation may not maintain an action, suit, or proceeding in a court of the state arising from the conduct of affairs by the corporation in the state.<sup>38</sup> However, the forfeiture of the right to conduct affairs in the state does not impair the validity of a contract or act of the corporation or prevent the corporation from defending an action, suit, or proceeding in a court of the state.<sup>39</sup>

Failure of a corporation that has forfeited its right to conduct affairs in the state to reinstate that right is grounds for the involuntary termination of the domestic corporation or the revocation

<sup>33</sup> *In re Am. Heartland Sagebrush § Invs., Inc.*, 334 B.R.848 (Bankr. N.D. Tex. 2005).

<sup>34</sup> *In re ABZ Ins. Servs., Inc.*, 245 B.R. 255 (Bankr. N.D. Tex. 2000).

<sup>35</sup> *Suntide Sandpit, Inc. v. H & H Sand and Gravel, Inc.*, No. 13-11-00323-0CV, 2012 WL 2929605 (Tex.App.–Corpus Christi July 19, 2012, pet. denied).

<sup>36</sup> *Cognata v. Down Hole Injection, Inc.*, 375 S.W.3d 370, 376 (Tex.App.–Houston [14th Dist.] 2012, pet. denied).

<sup>37</sup> *Robinette v. Merrill Lynch, Pierce, Fenner & Smith*, Civil Action Nos. 3:96-CV-2923-D, 3:97-CV-0353-D, 2004 WL 6389547 (N.D. Tex. Nov. 23, 2004).

<sup>38</sup> TEX. BUS. ORGS. CODE ANN. § 22.362 (West 2015).

<sup>39</sup> TEX. BUS. ORGS. CODE ANN. § 22.362(c) (West 2015).

of the foreign corporation's registration to transact business in the state.<sup>40</sup> The termination or revocation takes effect, without judicial action, when the Secretary of State enters on the record of the corporation filed in the office of the Secretary of State the word *forfeited* and the date of forfeiture and cites this chapter as authority for that forfeiture.<sup>41</sup>

## **REINSTATEMENT**

### **Reinstatement Under Chapter 11 of the BOC**

The Secretary of State will reinstate a filing entity that has been involuntarily terminated under Chapter 11 of the BOC if the entity files a certificate of reinstatement and: (1) the entity has corrected the circumstances that led to the involuntary termination and any other circumstances that may exist of the types described by § 11.251(b), including the payment of fees, interest, or penalties or (2) the Secretary of State finds that the circumstances that led to the involuntary termination did not exist at the time of termination.<sup>42</sup> A certificate of reinstatement must be accompanied by: (1) each amendment to the entity's certificate of formation that is required by intervening events, including circumstances requiring an amendment to the filing entity's name and (2) a tax clearance letter from the Comptroller stating that the filing entity has satisfied all franchise tax liabilities and may be reinstated, if the filing entity is a taxable entity under Chapter 171 of the Tax Code, other than a nonprofit corporation.<sup>43</sup>

If a filing entity is reinstated before the third anniversary of the date of its involuntary termination, the entity is considered to have continued in existence without interruption from the date of termination.<sup>44</sup> The reinstatement shall have no effect on any issue of personal liability of the governing persons, officers, or agents of the filing entity during the period between termination and reinstatement.<sup>45</sup> Under the BOC, a filing entity whose certificate of formation has been forfeited under the provisions of the Tax Code must follow the procedures in the Tax Code to reinstate its certificate of formation.<sup>46</sup> Reinstatement under the Tax Code follows below.

### **Reinstatement Under Chapter 171 of the Tax Code**

A corporation whose charter or certificate of authority is forfeited under the Tax Code by the Secretary of State is entitled to have its charter or certificate revived and to have its corporate privileges revived if: (1) the corporation files each report that is required by this chapter and that is delinquent; (2) the corporation pays the tax, penalty, and interest that is imposed by this chapter and that is due at the time of the request under § 171.313 of the code to set aside forfeiture is made; and (3) the forfeiture of the corporation's charter or certificate is set aside in a proceeding under § 171.313 of the code.<sup>47</sup> The Secretary of State may, using the same procedures it uses in relation to the revival of a corporation's charter or certificate, revive the certificate or registration of a taxable entity.<sup>48</sup> In regards to corporate privileges, if the Secretary of State sets aside under this chapter

<sup>40</sup> TEX. BUS. ORGS. CODE ANN. § 22.364 (West 2015).

<sup>41</sup> TEX. BUS. ORGS. CODE ANN. § 22.364 (West 2015).

<sup>42</sup> TEX. BUS. ORGS. CODE ANN. § 11.253(a) (West 2015).

<sup>43</sup> TEX. BUS. ORGS. CODE ANN. § 11.253(c) (West 2015).

<sup>44</sup> TEX. BUS. ORGS. CODE ANN. § 11.253(d) (West 2015).

<sup>45</sup> TEX. BUS. ORGS. CODE ANN. § 11.253(d) (West 2015).

<sup>46</sup> TEX. BUS. ORGS. CODE ANN. § 11.254 (West 2015).

<sup>47</sup> TEX. BUS. ORGS. CODE ANN. § 171.312 (West 2015).

<sup>48</sup> TEX. TAX CODE ANN. § 171.3125(a) (West 2015).

the forfeiture of a corporation's charter or certificate of authority, the Comptroller shall revive the corporate privileges of the corporation.<sup>49</sup>

### **Reinstatement Under Chapter 22 of the BOC**

A nonprofit corporation that has been involuntarily terminated for failure to file a periodic report may be reinstated by filing the report required by § 22.357, accompanied by the filing fee for the report, if the corporation has paid: (1) all fees, taxes, penalties, and interest due and accruing before the termination or revocation and (2) an amount equal to the total taxes from the date of termination or revocation to the date of reinstatement that would have been payable if the corporation had not been terminated or had its registration revoked.<sup>50</sup>

### **CONCLUSION**

The procedures for an entity that has been either involuntarily terminated or forfeited and is seeking reinstatement are summarized below:

Involuntary terminations under Chapter 11 of the BOC occur due to the failure to file the required report, pay the fee or penalty, maintain a registered agent or registered office, or a failure to pay or dishonor of a formation filing fee. Notice is sent by the Secretary of State followed by the issuance of a certificate of involuntary termination. The entity's existence terminates except for a three-year survival period for purposes of winding up, which includes suits on existing claims. Reinstatement under Chapter 11 requires a entity to file a certificate of reinstatement, *Form 811-Certificate of Reinstatement*, detailing the circumstances and any other grounds that led to the termination or the Secretary of State can find that the circumstances that led to termination did not exist. A tax clearance letter from the Comptroller must accompany the certificate of reinstatement. The entity's name must still be available. If the name is not available, the entity must simultaneously submit a consent or certificate of amendment to change its name. The reinstatement allows the entity to be considered to have continued without interruption if the reinstatement is within three years of termination. However, reinstatement has no effect on the personal liability of governing persons, officers, or agents of the entity during the period between termination and reinstatement.

Forfeiture of corporate and business privileges under Chapter 171 of the Tax Code occurs due to the failure to file the required report or pay the tax or penalty, if applicable, within 45 days after the Comptroller mails the notice of forfeiture. As a result, a corporation may not sue or defend in a court in Texas. Further, each director and officer has personal liability for the debts of the corporation incurred after the required report, tax, or penalty was due as provided by. In a suit against the corporation on a cause of action arising before forfeiture, affirmative relief may not be granted to the corporation unless the corporation's privileges are revived.

Forfeiture of the a certificate of formation under Chapter 171 of the Tax Code by the Secretary of State arises when the Comptroller sends a certification to the Secretary of State that the corporation has not revived its corporate privileges within 120 days of forfeiture. The Secretary of State subsequently forfeits the corporation's charter by inscribing a record to change the entity's status to forfeited. A forfeited corporation is a terminated entity for purposes of BOC Chapter 11 and survives for the three-year post-termination survival period for winding up, including suits on existing claims. The Comptroller revives business privileges if the corporation pays the tax, penalty, or interest before forfeiture of its charter. For reinstatement after a tax forfeiture, the

<sup>49</sup> TEX. TAX CODE ANN. § 171.314 (West 2015).

<sup>50</sup> TEX. BUS. ORGS. CODE ANN. § 22.365(a) (West 2015).

corporation must file each report and pay the tax, penalty, and interest due. *Form 801-Application for Reinstatement and Request to Set Aside Tax Forfeiture*, along with a tax clearance letter from the Comptroller, is filed by a director, officer, or stockholder, at the time of forfeiture, requesting the Secretary of State to set aside the forfeiture. As previously mentioned, the corporation's name must still be available or an amended name change must be filed. The Secretary of State sets aside the forfeiture of the charter and the Comptroller revives the corporation's privileges.

Forfeitures of the right to do business and involuntary terminations by nonprofit corporation's under Chapter 22 of the BOC result from a failure to file the periodic report when notified by the Secretary of State. The entity is notified by the Secretary of State to file the report within 30 days of notice. Failure to file the report when it is due results in forfeiture of the right to conduct affairs. Notice of forfeiture is sent by the Secretary of State to the entity's registered agent. A nonprofit corporation in forfeited rights status may not maintain an action in court in Texas, however the status does not impair the contracts of the nonprofit corporation or prevent it from defending an action. The certificate of involuntary termination is issued by the Secretary of State if the entity fails to further file the report and revive its right to transact business within 120 days of mailing of the notice of forfeited rights. As a result, the nonprofit corporation status is changed to inactive (i.e., involuntarily terminated). To reinstate the forfeiture, the nonprofit corporation must file *Form 802-Periodic Report – Nonprofit Corporation*, pay a filing fee, and a late fee within 120 days after mailing of the notice of forfeiture. The Secretary of State revives the entity's right to conduct affairs and the forfeited status is changed. In order to reinstate an involuntary termination, the entity must also file *Form 802* and pay a filing fee. The Secretary of State reinstates the certificate of formation and updates the status of the entity.

Businesses and their attorneys should periodically check the entity's franchise tax account status with the Texas Comptroller's Office to verify that the entity has the right to transact business in Texas. In the event the entity has involuntarily terminated or forfeited its business status, following the procedures in this article will get the entity back to business.



## AVOIDING IMPUTED DISQUALIFICATION

MICHAEL S. CEDILLO, LAURA SULLIVAN AND DIANA BROWN<sup>1</sup>

### Abstract

*Notwithstanding limited circumstances for previous government attorneys, Texas does not allow screening to circumvent imputed disqualification. To the contrary, an entire law firm is often disqualified from representation because one of its attorneys represented a former client at his or her previous firm that is now adverse – even if the disqualified attorney has no involvement in the actual case. Almost half the states and the American Bar Association Model Rules provide an exception to this harsh rule provided that the disqualified attorney is properly screened from the litigation. The reasoning is sound. The concern that confidential information will be revealed to the former client’s detriment is alleviated by properly screening the otherwise disqualified attorney. Meanwhile, a party is not deprived of its right to be represented by an attorney of its choosing and it allows attorneys mobility with changing jobs. Texas should adopt a similar rule for the same rationale.*

### I. Introduction

Imputed disqualification arises when an entire law firm is disqualified from representation because one of its attorneys has a conflict of interest. To avoid this potential conflict, ethical screening (commonly referred to as a “Chinese Wall”) is often used. Ethical screening is a procedure in which an otherwise disqualified attorney is screened from other attorneys within a firm to prevent the entire firm from being disqualified. A conflict of interest takes multiple forms. The following article focuses on a conflict of interest from an attorneys’ representation of a prior client and examines the law on ethical screening in Texas, other jurisdictions and the American Bar Association (“ABA”) Model Rules’ approach to ethical screening, and why Texas should adopt a similar rule.

### II. The Current Law in Texas

#### A. Imputed Disqualification

Under the Texas Disciplinary Rules of Professional Conduct, an entire law firm is disqualified if one of its attorneys has a conflict of interest unless the former client provides written consent.<sup>2</sup>Specifically, Rule 1.09 – “Conflict of Interest: Former Client” – states the following:

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<sup>2</sup>Tex.Disciplinary R. Prof. Conduct 1.09 cmt. 7 (“the effect of paragraph (b) is to extend any inability of a particular lawyer under paragraph (a) to undertake a representation against a former client to all other lawyers who are or become members of or associated with any firm in which that lawyer is practicing.”)

- (a) Without prior consent, a lawyer who personally has formerly represented a client in a matter shall not thereafter represent another person in a matter adverse to the former client:
  - (1) in which such other person questions the validity of the lawyer's services or work product for the former client;
  - (2) if the representation in reasonable probability will involve a violation of Rule 1.05 ["Confidentiality of Information"]; or
  - (3) if it is the same or a substantially related matter.
- (b) Except to the extent authorized by Rule 1.10 [relating to former government attorneys], when lawyers are or have become members of or associated with a firm, none of them shall knowingly represent a client if any one of them practicing alone would be prohibited from doing so by paragraph (a).<sup>3</sup>

Texas Courts have consistently looked to the Texas Disciplinary Rules when determining whether a law firm should be disqualified.<sup>4</sup>In doing so, the Courts have routinely held that a law firm is disqualified on the basis of imputed disqualification.<sup>5</sup>The Court's rationale for imputed disqualification is to protect confidential information from being revealed and there is a presumption that confidential information is shared among all attorneys within a firm.<sup>6</sup> Texas has made clear that this presumption cannot be rebutted by an ethical screening wall.<sup>7</sup>

Moreover, despite the fact that the plain language of Rule 1.09 concerns "former clients," the Texas Supreme Court has gone as far as holding that an entire firm was disqualified when it was

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<sup>3</sup> Tex. Disciplinary R. Prof. Conduct 1.09(a)-(b).

<sup>4</sup> See *National Medical Enterprises, Inc. v. Godbey*, 924 S.W.2d 123, 132 (Tex.1996) ("The Texas Disciplinary Rules of Professional Conduct do not determine whether counsel is disqualified in litigation, but they do provide guidelines and suggest the relevant considerations.") (citing *Henderson v. Floyd*, 891 S.W.2d 252, 254 (Tex.1995) (per curiam); *Spears v. Fourth Court of Appeals*, 797 S.W.2d 654, 656 (Tex.1990); and *Ayres v. Canales*, 790 S.W.2d 554, 556 n. 2 (Tex.1990)).

<sup>5</sup> See, e.g., *Nat's Med. Enters. V. Godbey*, 924 S.W.2d 123 (Tex. 1996) and *In re Epic Holdings, Inc.*, 985 S.W.2d 41, 49 (Tex. 1998).

<sup>6</sup> See *National Medical Enterprises, Inc. v. Godbey*, 924 S.W.2d 123, 132 (Tex.1996); see also *In re Guaranty Insurance Services, Inc.*, 343 S.W.3d 130, 133-134 (Tex.2011) (citing *In re Columbia Valley Healthcare System, L.P.*, 320 S.W.3d 819, 833-834 (Tex.2010) and *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831, 833 (Tex.1994) ("We have held that a lawyer who has previously represented a client may not represent another person on a matter adverse to the client if the matters are the same or substantially related. If the lawyer works on a matter, there is an irrebuttable presumption that the lawyer obtained confidential information during the representation. When the lawyer moves to another firm and the second firm represents an opposing party to the lawyer's former client, a second irrebuttable presumption arises—that the lawyer has shared the client's confidences with members of the second firm. The effect of this second presumption is the mandatory disqualification of the second firm.")).

<sup>7</sup> See Tex. Comm. On Professional Ethics Opinion 569 (2006) (citing *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831 (Tex. 1994) ("The Supreme Court of Texas refused to accept the concept of a screening of a conflicted lawyer from other lawyers in a law firm (sometimes referred to as a 'Chinese Wall') in order to allow representation by the law firm. That refusal is based upon the conclusive presumption that confidential information is shared among all lawyers in a firm."))

undisputed that none of the firm's attorneys had previously represented the adverse party.<sup>8</sup>In *National Medical Enterprises, Inc. v. Godbey*, National Medical Enterprises, Inc., Psychiatric Institutes of America, Inc., and other related entities (hereinafter "NME") were accused of mistreating its patients and committing fraud by charging for unnecessary medical treatments.<sup>9</sup> This led to criminal charges and civil lawsuits against NME and its employees.<sup>10</sup> NME retained Ed Tomko to represent two of NME's employees.<sup>11</sup> Mr. Tomko represented these employees while he was with Doke & Riley and later with Baker & Botts.<sup>12</sup> It was undisputed that Mr. Tomko never represented NME.<sup>13</sup> But, he did receive some of NME's confidential information that was subject to a joint defense agreement.<sup>14</sup> Several months after Mr. Tomko withdrew as the attorney for NME's employees, Baker & Botts (and attorneys who had no involvement in representing NME's former employees) filed suit against NME on behalf of a large number of NME's former patients.<sup>15</sup>

The issue on appeal was whether Mr. Tomko and his firm were disqualified when none of its attorneys, including Mr. Tomko, previously represented NME. The Court looked to other jurisdictions for guidance and in doing so, the Court noted that "[i]n each of these cases disqualification was based, not on the attorney's former representation of an opposing party, but on the attorney's duty to the party to preserve its confidences" and ultimately held that Mr. Tomko was disqualified.<sup>16</sup> The Court also disqualified Mr. Tomko's firm based on imputed disqualification.<sup>17</sup> The Court did so despite the following:

- 1) NME offered no evidence that Mr. Tomko had in fact disclosed confidential information to the attorneys prosecuting the lawsuit against NME;
- 2) Baker & Botts properly screened Mr. Tomko; and
- 3) "[t]he district court found 'that there [was] no reasonable probability that Baker & Botts will knowingly or unknowingly' disclose confidential information" during the lawsuit.<sup>18</sup>

A strong dissent expressed its opposition to the majority's opinion and held that "there is no basis for disqualification under Rule 1.09(a)(2)."<sup>19</sup> The dissent noted that it had been over a year since Mr. Tomko represented NME's employees, there was no allegation that Mr. Tomko's firm had in fact received confidential information and Mr. Tomko was properly screened.<sup>20</sup>

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<sup>8</sup>See *National Medical Enterprises, Inc. v. Godbey*, 924 S.W.2d 123, 132 (Tex.1996).

<sup>9</sup>*Id.* at 124.

<sup>10</sup>*Id.*

<sup>11</sup>*Id.*

<sup>12</sup>*Id.*

<sup>13</sup>*Id.*

<sup>14</sup>*Id.* at 125.

<sup>15</sup>*Id.*

<sup>16</sup>*Id.* at 131.

<sup>17</sup>*Id.* at 135.

<sup>18</sup>*Id.* at 131.

<sup>19</sup> *Id.* at 145.

<sup>20</sup>*Id.* at 144-145.

This is not the first time Texas Courts have held that screening could not be used to circumvent imputed disqualification. The issue first appeared in *Petroleum Wholesale, Inc. v. Marshall*, 751 S.W.2d 295 (Tex.App.–Dallas 1988, orig. proceeding).<sup>21</sup> Here, a young associate attorney worked for a plaintiff's firm before moving jobs to a defense firm.<sup>22</sup> While at the plaintiff's firm, the associate did not personally work on the cases at issue, but participated in confidential discussions, including strategy and settlement negotiations.<sup>23</sup> When the young associate moved to the defense firm, the defense firm implemented the following screening procedure:

- 1) it removed all files at issue from the central file room;
- 2) secured the files at issue in a storage room that had a lock with a key;
- 3) only lead counsel had access to the key;
- 4) the young associate was told not to discuss any of his previous cases with any attorney at the defense firm;
- 5) all defense firm employees were instructed not to discuss the cases at issue with the young associate;
- 6) if the young associate stumbled upon a conversation relating to the cases at issue then he was instructed to make his presence known and conversations relating to the cases at issue were to stop;
- 7) everybody at the firm was instructed not to leave any part of the file at issue unattended; and
- 8) any violation of these enumerated screening rules resulted in termination.<sup>24</sup>

On appeal, the issue was whether Texas authorized screening to prevent imputed disqualification and, if so, whether the defense firm's screening was sufficient.<sup>25</sup> There was no need for the Court to address the latter issue because it held that an ethical screening wall could not rebut the presumption that a disqualified attorney would share confidential information with his or her new firm.<sup>26</sup>

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<sup>21</sup> It should be noted that this "decision was based in part on Canon 9 of the Texas Code of Professional Responsibility, which required a lawyer to avoid the appearance of impropriety ... the new Disciplinary Rules of Professional Conduct, effective January 1, 1990, do not include any similar prohibition." *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831, 836 n. 1 (Tex.1994)

<sup>22</sup>*Id.* at 296.

<sup>23</sup>*Id.*

<sup>24</sup>*Id.*

<sup>25</sup>*Id.* at 297

<sup>26</sup>*Id.* at 300 ("To the contrary, we hold that the erection of a Chinese wall will not rebut the presumption of shared confidences when an attorney in private practice has actual knowledge of a former client's confidences in relation to a particular suit and he thereafter undertakes employment with a firm representing an adversary of the former client in that same suit.")

## B. When Ethical Screening is Permitted

The Texas Disciplinary rules allow ethical screening under limited circumstances for successive government attorneys, adjudicatory officials and former law clerks to adjudicatory officials. Pursuant to Rule 1.10, a law firm that would otherwise be disqualified because of imputed disqualification may continue with its representation if the former government attorney “is screened from any participation in the matter and is apportioned no part of the fee therefrom ... and ... written notice is given with reasonable promptness to the appropriate government agency.”<sup>27</sup> A similar screening procedure applies to former adjudicatory officials and law clerks.<sup>28</sup> The only difference between these two rules is that Rule 1.11 requires that “written notice [must] promptly be given to the other parties to the proceeding.”<sup>29</sup> The rationale behind permitting screening under these circumstances is to prevent qualified attorneys from being discouraged from working for government agencies out of fear that they will not secure employment in the private sector because potential employers do not want to be disqualified.<sup>30</sup>

The Texas Supreme Court has also permitted screening for nonlawyers.<sup>31</sup> In *Phoenix Founders, Inc. v. Marshall*, Denise Hargrove (a paralegal) left her position at Thompson & Knight to work for David & Goodman.<sup>32</sup> At David & Goodman, Ms. Hargrove worked on the case at issue (but, billed less than an hour) and spoke with lead counsel regarding the same.<sup>33</sup> Ms. Hargrove returned to Thompson & Knight as a paralegal after working for David & Goodman for only three weeks.<sup>34</sup> Upon her return to Thompson & Knight, David & Goodman argued that Thompson & Knight should be disqualified based upon the two irrebuttable presumptions that had previously been applied to attorneys: the first presumption being that confidential information is revealed to the attorney during prior representation and the second presumption being that the attorney will share this information with his or her new firm.<sup>35</sup> The Court agreed that Ms. Hargrove was subject to the first presumption.<sup>36</sup> But, the Court disagreed “with the argument that paralegals should be conclusively presumed to share confidential information with members of their firms.”<sup>37</sup>

The Court first noted that the Texas Disciplinary Rules require attorneys to supervise its legal staff and ensure their conduct is in line with the professional obligations owed to an attorney.<sup>38</sup> Pursuant to the Disciplinary Rules, an attorney can be subject to discipline if he or she orders or encourages the legal staff to engage in wrongful conduct.<sup>39</sup> “Thus, to the extent the Disciplinary Rules prohibit a lawyer from revealing confidential information, R. 1.05(b)(1), they also prohibit a supervising lawyer from ordering, encouraging, or permitting a nonlawyer to reveal

<sup>27</sup>Tex. Disciplinary R. Prof. Conduct 1.10(b)(1)(2).

<sup>28</sup>Tex. Disciplinary R. Prof. Conduct 1.11.

<sup>29</sup>Tex. Disciplinary R. Prof. Conduct 1.11(c).

<sup>30</sup>See *Petroleum Wholesale, Inc. v. Marshall*, 751 S.W.2d 297 (Tex.App.—Dallas 1988, orig. proceeding) (citing *Amoco Chemicals Corp. v. MacArthur*, 568 F.Supp. 42, 47 (N.D.Ga.1983)).

<sup>31</sup>See *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831 (Tex.1994)

<sup>32</sup>*Id.* at 833.

<sup>33</sup>*Id.* at

<sup>34</sup>*Id.* at

<sup>35</sup>*Id.* at

<sup>36</sup>*Id.* at 834.

<sup>37</sup>*Id.*

<sup>38</sup>*Id.* (citing Tex. Disciplinary R. Prof. Conduct 5.03(a)).

<sup>39</sup>*Id.*

such information.”<sup>40</sup>The Court also looked to the ABA’s Committee on Professional Ethics for guidance, as follows:

After surveying case law and ethics opinions from a number of jurisdictions, the Committee concluded that the new firm need not be disqualified, as long as the firm and the paralegal strictly adhere to the screening process set forth in the opinion, and as long as the paralegal does not reveal any information relating to the former employer’s clients to any person in the employing firm.<sup>41</sup>

The Court further noted that there was a concern regarding limiting a paralegal’s mobility with changing jobs because a potential hiring firm may be disinclined to hire them out of fear of being disqualified from ongoing litigation.<sup>42</sup> The Court held that the former client’s privileged information could be protected through proper screening.<sup>43</sup> In other words, if the confidential information is properly safeguarded through ethical screening, then the presumption that confidential information will be shared within a firm can be rebutted.<sup>44</sup> The Court made clear, however, that disqualification will always be the appropriate remedy when confidential information has in fact been shared or “when screening would be ineffective.”<sup>45</sup> With this in mind, the Texas Supreme Court instructed the trial court to determine whether Thompson & Knight’s screening was effective.<sup>46</sup> In doing so, the trial court was provided with the following factors to consider:

- 1) “the substantiality of the relationship between the former and current matters;”
- 2) “the time elapsing between the matters;”
- 3) “the size of the firm;”
- 4) “the number of individuals presumed to have confidential information;”
- 5) “the nature of their involvement in the former matter;” and
- 6) “the timing and features of any measures taken to reduce the danger of disclosure.”<sup>47</sup>

### **III. The Ethical Screening Wall Permitted in Other Jurisdictions and the ABA**

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<sup>40</sup>*Id.*

<sup>41</sup>*Id.* (citing ABA Comm. On Ethics and Professional Responsibility, Informal Op. 1526 (1988)).

<sup>42</sup>*Id.* at 835.

<sup>43</sup>*Id.*

<sup>44</sup>*Id.*

<sup>45</sup>*Id.*

<sup>46</sup>*Id.*

<sup>47</sup>*Id.* at 836.

The following twenty-four states have some form of a screening wall preventing unnecessary imputed disqualification for attorneys:

Arizona <sup>48</sup>	Massachusetts <sup>56</sup>	Ohio <sup>64</sup>
Colorado <sup>49</sup>	Michigan <sup>57</sup>	Oregon <sup>65</sup>
Delaware <sup>50</sup>	Minnesota <sup>58</sup>	Pennsylvania <sup>66</sup>
Illinois <sup>51</sup>	Montana <sup>59</sup>	Rhode Island <sup>67</sup>
Iowa <sup>52</sup>	Nevada <sup>60</sup>	Tennessee <sup>68</sup>
Indiana <sup>53</sup>	New Jersey <sup>61</sup>	Utah <sup>69</sup>
Kentucky <sup>54</sup>	North Carolina <sup>62</sup>	Washington <sup>70</sup>
Maryland <sup>55</sup>	North Dakota <sup>63</sup>	Wisconsin <sup>71</sup>

The ABA has also adopted a rule allowing ethical screening to cure imputed disqualification. Specifically, Rule 1.10 – “Imputation of Conflicts of Interest” – of the ABA Model Rules of Professional Conduct provides the following:

- (a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless
  - (1) the prohibition is based on a personal interest of the disqualified lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm; or

<sup>48</sup>See Ariz. Rules of Prof'l Conduct R. 1.10(d).

<sup>49</sup>See Colo. Rules of Prof'l Conduct R. 1.10(d).

<sup>50</sup>See Del. Rules of Prof'l Conduct R. 1.10(c)(1).

<sup>51</sup>See Ill. Rules of Prof'l Conduct R. 1.10(b)(2).

<sup>52</sup>See Iowa Rules of Prof'l Conduct R. 32:1.7 & 32:1.10.

<sup>53</sup>See Ind. Rules of Prof'l Conduct R. 1.10(c).

<sup>54</sup>See Ky. Rules of Prof'l Conduct R. 3.130 (1.10)(d).

<sup>55</sup>See Md. Rule of Professional Conduct 1.10(b).

<sup>56</sup>See Mass. Rules of Prof'l Conduct R. 1.10(d)(2)(ii).

<sup>57</sup>See Mich. Rules of Prof'l Conduct R. 1.10(b)(1).

<sup>58</sup>See Minn. Rules of Prof. Conduct R. 1.10(b)(2).

<sup>59</sup>See Mont. Rules of Prof'l Conduct R. 1.10(c)(1).

<sup>60</sup>See Nev. Rules of Prof'l Conduct R. 1.10(e).

<sup>61</sup>See N.J. Rules of Prof'l Conduct R. 1.10(c)(2).

<sup>62</sup>See N.C. Rules of Prof'l Conduct R. 1.10(c)(1).

<sup>63</sup>See N.D. Rules of Prof'l Conduct R. 1.10(b).

<sup>64</sup>See Ohio Rules of Prof'l Conduct R. 1.10(c)-(d).

<sup>65</sup>See Or. Rules of Conduct R. 1.10(c) (2005).

<sup>66</sup>See Pa. Rules of Prof'l Conduct R. 1.10(b)(1) (2004).

<sup>67</sup>See R.I. Rules of Prof'l Conduct R. 1.10(c)(1).

<sup>68</sup>See Tenn. Rules of Prof'l Conduct R. 1.10(c) (2005).

<sup>69</sup>See Utah Rules of Prof'l Conduct R. 1.10(c).

<sup>70</sup>See Wash. Rules of Prof'l Conduct R. 1.10(b) (2005).

<sup>71</sup>See Wis. Rules of Prof'l Conduct R. 20:1.10(a).

- (2) the prohibition is based upon Rule 1.9(a) or (b) and arises out of the disqualified lawyer's association with a prior firm, and
  - (i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom;
  - (ii) written notice is promptly given to any affected former client to enable the former client to ascertain compliance with the provisions of this Rule, which shall include a description of the screening procedures employed; a statement of the firm's and of the screened lawyer's compliance with these Rules; a statement that review may be available before a tribunal; and an agreement by the firm to respond promptly to any written inquiries or objections by the former client about the screening procedures; and
  - (iii) certifications of compliance with these Rules and with the screening procedures are provided to the former client by the screened lawyer and by a partner of the firm, at reasonable intervals upon the former client's written request and upon termination of the screening procedures.<sup>72</sup>

In 2009, prior to the ABA adopting Rule 1.10, the ABA Standing Committee on Ethics and Professional Responsibility submitted its Recommendation to the ABA House of Delegates to adopt this rule. In doing so, the committee "carefully considered the issues relating to imputed disqualification, and concluded that it is time for the American Bar Association to extend the concept of screening, which the Model Rules have long permitted in other contexts, to lawyers who move between private firms."<sup>73</sup> The Committee identified several concerns with imputed disqualification, including the client being stripped of retaining counsel of its choice and concern over lawyer mobility.<sup>74</sup> The Committee pointed out that the notion of having to choose between protecting a client and attorney mobility is a "false choice" because both can be protected.<sup>75</sup> Indeed, "[s]creening is a mechanism to give effect to the duty of confidentiality, not a tool to undermine it."<sup>76</sup> The Committee conducted research on other states that had adopted a similar rule and noted that screens effectively protected a former client's privileged information.<sup>77</sup> The Committee also pointed out that the ABA has already adopted a similar rule in 1983 (and when the rules were first adopted) for attorneys moving from the government to private sector, as have many states, and "the Committee has not been aware of even a handful of instances in which

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<sup>72</sup> ABA Rules of Professional Conduct R. 1.10 (a).

<sup>73</sup> American Bar Association Standing Committee on Ethics and Professional Responsibility Report to the House of Delegates Recommendation 109, pg. 5 (2009).

<sup>74</sup> *Id.* at 5-7.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 6.

<sup>77</sup> *Id.*

confidentiality has been breached.”<sup>78</sup>To the contrary, “[t]he Committee is unaware of evidence that governmental clients have seen their confidences eroded through breaches of the screen.”<sup>79</sup>

#### IV. Texas Should Allow For Ethical Screening to Prevent Unnecessary Imputed Disqualification

Given the strong public policy supporting a client’s right to retain its counsel of choice, there is no question that if screening was guaranteed to be effective then there would be no real objection to Texas adopting a rule mirroring ABA’s Model Rule 1.10 (as pointed out by the Fifth Circuit Court of Appeals analyzing Texas Disciplinary Rule 1.09, “depriving a party of the right to be represented by the attorney of his or her choice is a penalty that must not be imposed without careful consideration ... [s]tated plainly, this sanction ‘must not be imposed cavalierly.’”<sup>80</sup>). The concern, however, is how do we know that it will actually work? Well, it already has. Texas law has permitted screening for prior governmental attorneys for over thirty years.<sup>81</sup>

The Texas Supreme Court also made clear (since 1994) that screening is permitted for nonlawyers.<sup>82</sup> Interestingly, the Court’s rationale for why nonlawyers can be properly screened is that they will be supervised by attorneys subject to the Texas Disciplinary Rules. If attorneys can be trusted to ensure that their legal staff will follow the disciplinary rules then the attorneys themselves should be trusted to do the same. The Court also noted the importance of a paralegal’s job mobility. The same concern should apply to attorneys (particularly young associates) as this is a true impediment to them, as illustrated below:

You are a young associate, fresh out of law school, hired by a large law firm that deals with anything from medical malpractice to construction contracts. After working at the firm for several years you decide to change firms. You interview with a number of firms, but after describing the variety of cases that you have worked on over the years, the firms admit that they do not want to risk hiring you and possibly having to turn down future litigation if a conflict of interest arises. The firms explain that any conflict you may have with a potential client will most likely prevent the entire firm from representing that client. Unfortunately for you, this is a financial risk the firms are not willing to take.<sup>83</sup>

This paper is not suggesting that each time a proper screening wall is effectuated that the trial court should deny a moving party’s motion to disqualify based upon imputed disqualification. Rather, this paper is merely suggesting that there not be mandatory disqualification based upon a presumption that an attorney will share the former client’s confidences with the members of his or her firm. There will always be situations where a trial court should grant a motion to disqualify based upon imputed disqualification even when the non-movant has a proper screening wall.

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<sup>78</sup>*Id.*

<sup>79</sup>*Id.* at 8.

<sup>80</sup>*In the Matter of: ProEducation International, Inc.*, 587 F.3d 296, 299-300 (5th Cir. 2009).

<sup>81</sup>*See* Tex. Disciplinary R. Prof. Conduct 1.10 and 1.11.

<sup>82</sup>*See Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831 (Tex. 1994)

<sup>83</sup>Erin A. Cohn, Comment, *The Use of Screens to Cure Imputed Conflicts of Interest: Why the American Bar Association’s and Most State Bar Associations’ Failure to Allow Screening Undermines the Integrity of the Legal Profession*, 35 U. BALT. L. REV. 367 (2006)

Indeed, the ABA's Model Rules provide that "even where screening mechanisms have been adopted, tribunals may consider additional factors in ruling upon motions to disqualify a lawyer from pending litigation."<sup>84</sup>In fact, the Texas Supreme Court has already provided guidance regarding factors that should be considered, including the substantiality of the relationship between the matters, how much time has elapsed, the size of the law firm, the number of people presumed to have confidential information, the nature of the disqualified person's involvement in the former matter, and the timing and mechanisms of any measures taken to reduce the danger of disclosure.<sup>85</sup>Thus, the trial court will always have discretion to disqualify a law firm in extraordinary circumstances.

## V. Conclusion

Thus, Texas should permit ethical screening walls to circumvent unnecessary imputed disqualification under the right circumstances because proper screening ensures that a former client's confidential information will be safeguarded. Meanwhile, a party is not deprived of its right to counsel of its choice and attorneys, as with nonlawyers and former government attorneys, will have more job mobility.

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<sup>84</sup>ABA Rules of Prof'l Conduct R 1.10 cmt 7.

<sup>85</sup>See *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831, 836 (Tex.1994).



## MEDIATION MADNESS II: DEALING WITH DESTRUCTIVE EMOTIONS

CHARLES BULTENA\*  
CHARLES RAMSER\*\*  
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*This paper offers insights into how to prepare for and conduct mediation when intense negative or destructive emotions arise by applying models and recent research from the field of group dynamics. Included are three tools to help mediators identify and deal with negative emotions in mediation and coping strategies to deal with these emotions at each phase of mediation.*

### I. INTRODUCTION

Mediation offers an alternative to the rigors of formal litigation in a courtroom. It has become a successful conflict resolution tool because it provides an opportunity to resolve virtually any issue in “a cost effective and timely manner.”<sup>1</sup> Moreover, according to Gene Valentini, director of the Texas Dispute Resolution System, one can speak freely in mediation “about anything you feel will get you to a point of resolution because nobody’s recording or saying it’s out of order, whereas in the courtroom you may not be able to address those things.”<sup>2</sup> When business leaders prepare for and manage a successful mediation, they will understand the dynamics of the process.

Applying models and recent research from the field of group dynamics, this paper offers insight into how to prepare for and conduct mediation when intense negative or destructive emotions arise. According to Daniel Shapiro, negative emotions disrupt or “hijack” rational thinking, while positive emotions contribute to interpersonal dynamics that enhance effective decision making.<sup>3</sup> Thus, negative emotions are potentially destructive and pose a threat to mediation success if they are not appropriately addressed. This article examines negative emotions and their impact on mediation. It offers three tools to help mediators identify and deal with negative emotions in mediation: a Continuum of Emotional Escalation to help mediators arrest exploding emotions; a Life Cycle Model of Destructive Emotions to help mediators identify key negative emotions likely to arise at each stage of mediation; and a Situational Model of Emotional Intelligence to help mediators match mediation style to the emotional readiness of participants. Finally, it puts forward coping strategies for dealing with destructive emotions at each phase of mediation. The extent to which business leaders recognize and respond to

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<sup>1</sup> Office of Dispute Resolution, *The Texas Resolution Connection*, Vol. 24, Issue 4, (Fourth Quarter, 2010), p. 2.

<sup>2</sup> *Ibid.*

<sup>3</sup> Shapiro, D., “Preempting Disaster: Premediation Strategies to Deal with Strong Emotions,” in Margaret Herrman (ed.), *The Blackwell Handbook of Mediation: A Guide to Effective Negotiation* (Oxford: Blackwell, 2006).

negative emotions can determine whether mediation succeeds. Before considering how skills can be developed in this area, it is important to examine the meaning of mediation, its use, and its success in resolving conflict.

## II. THE MEANING OF MEDIATION

Texas statutory law defines mediation this way:

- (a) Mediation is the forum in which an impartial person, the mediator, facilitates communication between parties to promote reconciliation, settlement, or understanding among them.
- (b) A mediator may not impose his own judgment on the issues or that of the parties.<sup>4</sup>

Unfortunately, this statutory definition offers little insight into what mediation actually can and should be. When successful, mediation can be characterized as proactive, forward-looking, and problem-solving in nature. As a process, it is enlightening, flexible, confidential, and, typically, evokes less stress than does formal litigation. It is not a drastic action and does not involve the surrender of freedom that arbitration dictates, as the latter requires an impartial third party who breaks a deadlock by issuing a final binding ruling.<sup>5</sup> Mediation basically involves negotiation through a disinterested third party, and it effectively can defuse emotional time bombs. One drawback mars this otherwise rosy picture: neither side is bound by anything in mediation. Arbitration binds; mediation intervenes benevolently. If the parties involved remain stubborn, intervention can sour, and mediation then becomes an exercise in futility.

Proactive use of mediation can help businesses keep conflict out of costly litigation and can even help settle conflicts already in litigation. For this to happen, though, business leaders must know what should transpire in mediation and how to prepare for it.

## III. THE USE OF MEDIATION

Over the past two decades, the use of mediation has exploded. Business leaders and the courts have discovered its value as a cost-effective alternative to litigation in the traditional adversarial system. The number of mediation cases in Texas, Oklahoma, and Nebraska (the states nearest the region to track statistics) is staggering. Cases received by Texas alternative dispute resolution centers in the most recent three-year period for which records were kept average almost 20,000 annually, with a total of more than 58,000 from 2003 to 2005.<sup>6</sup> The same situation is true of Oklahoma. As shown in Table 1, on average, more than 6,000 cases have been referred annually to the alternative dispute resolution system there, with 73,550 cases referred in just over a decade. Also, an impressive average settlement rate of 64 percent has been registered.<sup>7</sup> Farther north, results in Nebraska (see Table 2) are even more impressive. The number of cases referred annually to that state's alternative dispute resolution system has almost doubled in seven years, with an average settlement rate of 82 percent.<sup>8</sup> These striking regional

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<sup>4</sup> TEX. CIVIL PRACTICE AND REMEDIES CODE ANN. §154.023 (2008).

<sup>5</sup> Peter Lovenheim, *How to Mediate Your Dispute*, Boston, Irwin-McGraw Hill, 1998, p. 386.

<sup>6</sup> Annual Report of the Texas Judiciary, Office of Court Administration, 2005 (last year reported).

<sup>7</sup> Annual Report of ADR System, Supreme Court of Oklahoma Administrative Office of the Courts, 2003-2014.

<sup>8</sup> Annual Mediation Center Case Data Report, Nebraska Office of Dispute Resolution, 2008-2015.

**Table 1: Oklahoma Alternative Dispute Resolution System Cases Referred and Settlement Rate**

<i>Date</i>	<i>Cases</i>	<i>Settlement Rate</i>
2003	6,800	64%
2004	6,353	64%
2005	6,328	68%
2006	7,968	62%
2007	5,139	64%
2008	5,766	64%
2009	6,275	71%
2010	6,375	63%
2011	6,535	64%
2012	5,704	62%
2013	5,261	61%
2014	5,046	63%
<b>Total</b>	<b>73,550</b>	<b>64%</b>

**Source:** *Annual Report Alternative Dispute Resolution System* from the Supreme Court of Oklahoma Administrative Office of the Courts

**Table 2: Nebraska Alternative Dispute Resolution System Cases Referred and Settlement Rate**

<i>Date</i>	<i>Cases</i>	<i>Settlement Rate</i>
2008	1,171	84%
2009	1,467	83%
2010	1,604	85%
2011	1,723	83%
2012	1,876	81%
2013	1,948	79%
2014	2,133	79%
2015	2,083	78%
<b>Total</b>	<b>14,005</b>	<b>82%</b>

**Source:** *Annual Mediation Center Case Data Report* from the Nebraska Office of Dispute Resolution

settlement rates are mirrored across the United States (e.g., Better Business Bureau, 78%; U.S. Equal Employment Opportunity Commission, 70%; Financial Industry Regulatory Authority, 80%; and State of Florida Division of Administrative Hearings, 78.5%)<sup>9</sup> and internationally (e.g., World Intellectual Property Organization – exceeds 70% across its 188-member-nations).<sup>10</sup> Thus, the widespread use of mediation and its potential for cost-effective conflict resolution are well-established.

<sup>9</sup> 4 Disputes.com Mediation Exchange, *Published Results from Mediation*, [http://www.4disputes.com/mediation\\_statistics.html](http://www.4disputes.com/mediation_statistics.html), (last visited May 20, 2016) lead author retains a copy.

<sup>10</sup> World Intellectual Property Services, *WIPO Mediation Case Examples*, <http://www.wipo.int/amc/en/mediation/case-example.html> (last visited May 20, 2016) lead author retains a copy.

#### IV. PURPOSE

Mediation is a form of alternative dispute resolution that allows parties to avoid traditional litigation. Mediation parties agree to allow an impartial mediator to manage the process as they seek common ground and, hopefully, a win-win settlement. Because the parties are at odds initially, each attempts to influence the other in an effort to resolve the dispute. Negotiation, in general, has been assumed to be a rational process whereby the parties focused on substantive issues reach agreement. Emotions, while recognized as important, have been considered a hindrance to rational decision making. Thus, they must be subdued or de-emphasized. This view has been called into question in recent years. Emotions are an integral component of conflict. In fact, strong emotions, often negative, underlie most conflict. Negotiators and mediators, in particular, are recognizing that the goal is to “surface” emotion rather than to “suppress” it. Julie Denny, an experienced mediator and founder of Resolutions, recounts an age discrimination suit she mediated in which a CEO terminated a long-tenured vice president of marketing at age 54.<sup>11</sup> The VP filed a complaint mediated by Denny. The case was deadlocked until she commented in joint session that the parties seemed to know each other well. As the parties began to share how close they and their families had been over the years, the real issue surfaced. The VP’s sense of betrayal by his long-time friend, not age discrimination, was the real issue. The VP dropped the case, and the CEO ended up taking him to the airport. By the end of the mediation, they were making plans to re-unite their families in the near future. The VP didn’t get his job back, but the personal relationship, which was more important to the parties, was restored. This is the foundational nature of emotion in conflict.

A growing body of research in mediation supports the primacy of emotional issues in mediation. Some researchers, such as Shapiro<sup>12</sup>, advocate suppression of negative emotion, which hinders rational decision making, in favor of positive emotion that enhances it. However, many other researchers now argue that even negative emotion plays a foundational role in conflict resolution.<sup>13</sup> New research suggests that surfacing strong negative emotions underlying conflict in mediation, allowing parties to vent and explore foundational issues, opens the process and produces unexpected avenues for resolution.<sup>14</sup> Thus, negative emotion has taken center stage in mediation in recent years.

Only when business leaders understand these dynamics can they prepare for and manage a successful mediation, which is a process of partnership and persuasion. Compelling persuasion is based on effective, ethical influence tactics that recognize underlying emotions and preserve a personal relationship founded on trust, confidence, and integrity. This article acknowledges the role of negative or destructive emotions in mediation and offers mediators tools to recognize them and respond appropriately at each stage of mediation. Three vital tools for dealing with

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<sup>11</sup> Denny, J., The Importance of Emotions in Mediation, <http://www.mediate.com/articles/DennyJ2.cfm> (last visited Mar. 18, 2016) lead author retains a copy.

<sup>12</sup> Shapiro, D. 2002. Negotiating Emotions, *Conflict Resolution Quarterly*, 20 (1): 67-82.

Fisher, R. & Ury, W., *Getting to Yes: Negotiating Agreement Without Giving In*, (New York: Penguin Books, 1983), p. 11.

<sup>14</sup> *Ibid.*

negative emotions are suggested. First, the problem of escalating emotion is addressed in the Continuum of Emotional Escalation. Then, the literature is reviewed to identify the Top 10 negative emotions mediators are likely to encounter. These emotions are classified and plotted in the Life Cycle Model of Destructive Emotions in Mediation; this highlights the negative emotions mediators are most likely to encounter at each stage of the process. Coping strategies to neutralize each of these emotions are offered. Next, Emotional Intelligence is applied to mediation in the Situational Model of Emotional Readiness and Mediation Style, which prescribes the appropriate mediation style for the level of emotional maturity exhibited by participants. Recommendations for coping with negative emotions in mediation close out the section. These tools draw on current and classic research in social psychology and group dynamics to help mediation participants recognize and avoid the devastating effects of negative emotions on the mediation process. Effective use of these tools is vital to mediation success.

## V. DEALING WITH DESTRUCTIVE EMOTIONS IN MEDIATION

### A. CONTINUUM OF EMOTIONAL ESCALATION

Much of the training literature for negotiation and mediation suggests that emotions should be ignored as parties set their feelings aside and mediators steer disputants back toward rational behavior.<sup>15</sup> Fisher and Ury (1983) disagree, noting that strong emotions must be acknowledged and understood before the substance of the dispute can be addressed. Venting and exploring strong emotions, when properly managed, enhance opportunities for conflict resolution and create new settlement opportunities.<sup>16</sup> Addressing the “emotional core” of the conflict is vital to reaching a successful settlement, but managing the emotional processes underlying a dispute presents a major challenge to mediators.

Managing strong emotions is challenging due to the unique processes underlying emotion that impact the way we process and experience it. A key concern is the notion of emotional escalation. Strong emotions can function like a nuclear reactor. Mediators who allow participants to vent anger, for example, run the risk of not being able to control or stop the reaction. A controlled reaction is not always possible in mediation. The Continuum of Emotional Escalation in Figure 1 is offered to help mediators arrest exploding emotions and their negative impact on mediation. The process begins with Emotional Triggers, which are the foundation of all conflict. Conflict occurs when people perceive incompatible goals or interference from one another.<sup>17</sup> By definition, events that trigger conflict also trigger emotion.<sup>18</sup> Because the triggers are the same, “to recognize that we are in conflict is to acknowledge that we

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<sup>15</sup> Ibid., p. 3.

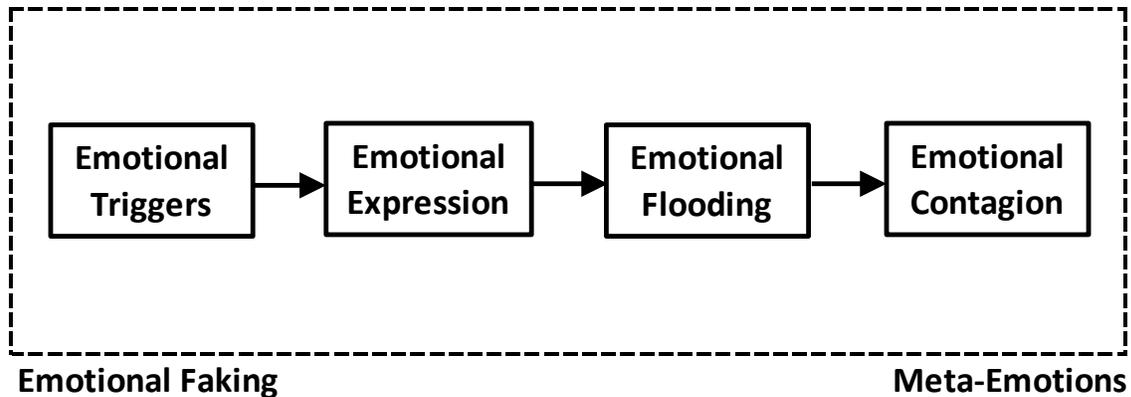
<sup>16</sup> Fisher, R. & Ury, W., *Getting to Yes: Negotiating Agreement Without Giving In*, (New York: Penguin Books, 1983), p. 11.

<sup>17</sup> Jones, T. & Bodtker, A., Mediating with Heart and Mind: Addressing Emotion in Mediation Practice, *Negotiation Journal*, July 2001, p. 221.

<sup>18</sup> Ibid.

have been emotionally triggered.”<sup>19</sup> Emotions and feelings greatly impact how people deal with conflict.<sup>20</sup> Conflicts often erupt “precisely because parties ignore their own or others’ feelings and emotions.”<sup>21</sup> Emotions are both a cause and an escalator of conflict.<sup>22</sup> Emotion is the foundation of all conflict and has a profound impact on conflict resolution.<sup>23</sup> Thus, it cannot be ignored in mediation.

**Figure 1: Continuum of Emotional Escalation**



As shown in Figure 1, emotional triggers lead to emotional expression -- the actual emotions experienced or manifested. Unfortunately, emotions are complex. They vary widely in intensity -- whether they are active (visible) or passive (subtle or hidden) -- and in their focus -- whether they are personal (directed toward individuals) or situational (directed toward the situation or process).<sup>24</sup> Thus, mediators must be skilled at reading and managing emotions, key components of emotional intelligence discussed later in this paper.<sup>25</sup> For example, mediators who allow participants to vent anger run the risk of it escalating into rage, leading to infuriated outbursts against other parties. Once it goes too far, it is difficult to dig out of the “black hole of anger.”<sup>26</sup> How much is enough? Nancy Holtz, former Massachusetts Superior Court judge and JAMS mediator, says it is particularly problematic when attorneys indulge themselves by “posturing and snarling” during mediation, creating unrealistic expectations and breaking the atmosphere of compromise.<sup>27</sup> The onset of strong emotions leads to the latter stages of escalation highlighted in Figure 1: Emotional Flooding and Emotional Contagion.

<sup>19</sup> Ibid.

<sup>20</sup> Maiese, M., Emotions, published on *Beyond Intractability*, <http://www.beyondintractability.org>, p. 1, (last visited May 20, 2016) lead author retains a copy.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Lieberman, A., The A List of Emotions in Mediation: From Anxiety to Agreement, *Dispute Resolution Journal*, Feb/Apr, 2006, p. 48.

<sup>25</sup> Goleman, D., *Emotional Intelligence*, New York: Bantam, 1997, p. 7.

<sup>26</sup> Maiese, Emotions, p. 4.

<sup>27</sup> Holtz, N., How the Inside Out of Emotions Affects the Inside of Mediation, *Alternatives*, Vol. 34:1, Jan 2016, p.4.

Intense emotion can lead to emotional flooding, which is a system overload that swamps the brain and blocks access to information from the neocortex.<sup>28</sup> When this happens, one cannot function or think clearly; hence the expression, “I’m so mad I can’t think straight!” Emotional flooding is not always triggered by external events. In some cases, people rehearse negative emotional experiences repeatedly in their minds, until they trigger their own emotional flooding.<sup>29</sup> Once emotional flooding occurs, it is wise to take a break from proceedings, because it usually takes about 20 minutes for a person who has flooded to return to a functional state.<sup>30</sup>

Further complicating emotional escalation and flooding is the final stage of the continuum, emotional contagion. Much like sneeze contagion, where one sneeze in a room full of people prompts a whole series of sneezes, strong emotions tend to be “caught” by others. People tend to “automatically mimic and synchronize facial expression, vocalizations, postures, and movements” with others to converge emotionally.<sup>31</sup> This is an unconscious process that can easily derail mediation. Mediators must be aware of the potential for emotional contagion when emotions run high and allow for venting in a private session at times.<sup>32</sup>

The whole escalation process is impacted by meta-emotions and emotional faking, represented by the rectangular area surrounding the escalation process in Figure 1. Both have the potential to impact the entire process. Meta-emotions are “emotions about emotions.”<sup>33</sup> They color or influence the primary emotion being experienced.<sup>34</sup> For example, a parent who is angry at a child but has the meta-emotion that it is wrong to be angry with children may suppress or alter the primary emotion. Thus, meta-emotions can be a form of unconscious bias that impacts the whole escalation process. Mediators must be aware of their own meta-emotions and how they may bias deliberations.

So far, the discussion has focused on genuine or felt emotion, but some emotions in mediation are faked. Faking has a profound impact on the escalation process. Mediation participants often fake anger to intimidate parties in order to win concessions. Others may fake sadness, acceptance, or joy. One telltale sign of faking is the brevity of a smile. If the smile evaporates in a couple of seconds, it most likely was fake. It is proposed that two distinct forms of faking exist in mediation: accommodative and manipulative. The former is cooperative in nature -- faking politeness, respect, acceptance, agreement, or humor to gain acceptance or to diffuse or avoid conflict. Manipulative faking has a more sinister purpose -- to gain influence through intimidation or to generate fear or discord in order to bolster one’s bargaining position or power. Mediators and participants must be skilled at reading emotions in order to detect the subtleties of faking. An unfortunate consequence of faking is emotional labor -- a form of stress

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<sup>28</sup> Perry et al., Childhood Trauma, the Neurobiology of Adaptation and Use-Dependent Development of the Brain: How States Become Traits, *Infant Mental Health Journal*, 16(4): 271-291.

<sup>29</sup> Jones & Bodtker, *Mediating with Heart and Mind*, p. 228.

<sup>30</sup> Gottman, J., *What Predicts Divorce? The Relationship Between Marital Processes and Marital Outcomes*. Hillsdale, N.J.: Lawrence Erlbaum.

<sup>31</sup> Jones & Bodtker, *Mediating with Heart and Mind*, p. 232.

<sup>32</sup> *Ibid.*, p. 233.

<sup>33</sup> *Ibid.*, p. 239.

<sup>34</sup> *Ibid.*

and emotional exhaustion.<sup>35</sup> The greater the emotional dissonance (gap between actual and expressed emotion), the greater the stress, emotional exhaustion, dissatisfaction with the process, and cynicism toward others.<sup>36</sup>

### B. LIFE CYCLE MODEL OF DESTRUCTIVE EMOTIONS IN MEDIATION

Having established the foundational role of emotions in conflict and negotiation and explored the dynamics of emotions in mediation, attention is directed toward specific emotions that can be destructive in mediation and strategies to deal with them. From a review of the literature, a “Top 10 List” of the most common destructive emotions encountered in mediation was created. Those emotions then were plotted according to their Focus (Personal or Situational); Manifestation (Active or Passive); and dominant Location (where they operate most strongly) in the mediation cycle (Pre-Mediation, Early Mediation, Late Mediation, and Settlement Phase). From this plotting, a Life Cycle Model of Destructive Emotions was created (Figure 2). Each quadrant represents a phase of the mediation cycle that is characterized by a particular emotional climate (Distressed, Disgusted, Disappointed, and Disillusioned). Also plotted was a large downward spiraling arrow that passes through all the phases of the model to represent the downward spiral of destructive emotions through the course of mediation. Strategies to Neutralize Destructive Emotions in Mediation is offered in Table 3 for each quadrant of the model.

#### **Quadrant 1 – Distressed – Pre-Mediation**

Anxiety is the most common experience of parties waiting for mediation to begin.<sup>37</sup> It is described as “a state of distress in reaction to threatening stimuli, particularly novel situations that have the potential for undesirable outcomes.”<sup>38</sup> This is an accurate description of the Pre-Mediation phase, especially for participants who are new to the process. The focus in this phase is on the Situation, the mediation process itself, and it is an Active emotion that is intense and visible. Seasoned participants pick up on non-verbal cues of anxiety (clenched hands, folded arms, hunched posture and strained facial expression) and may take advantage of anxious participants.<sup>39</sup> Research has shown that anxiety is a destructive emotion in this phase. Experiments conducted by Dr. Alison Wood Brooks of Harvard University showed that anxious negotiators made weaker offers, responded more quickly to moves made by counterparts, were

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<sup>35</sup> Grandey, A., When the Show Must Go On: Surface Acting and Deep Acting as Determinants of Emotional Exhaustion and Peer-Related Service Deliver, *Academy of Management Journal*, Feb. 2003, p. 86-96.

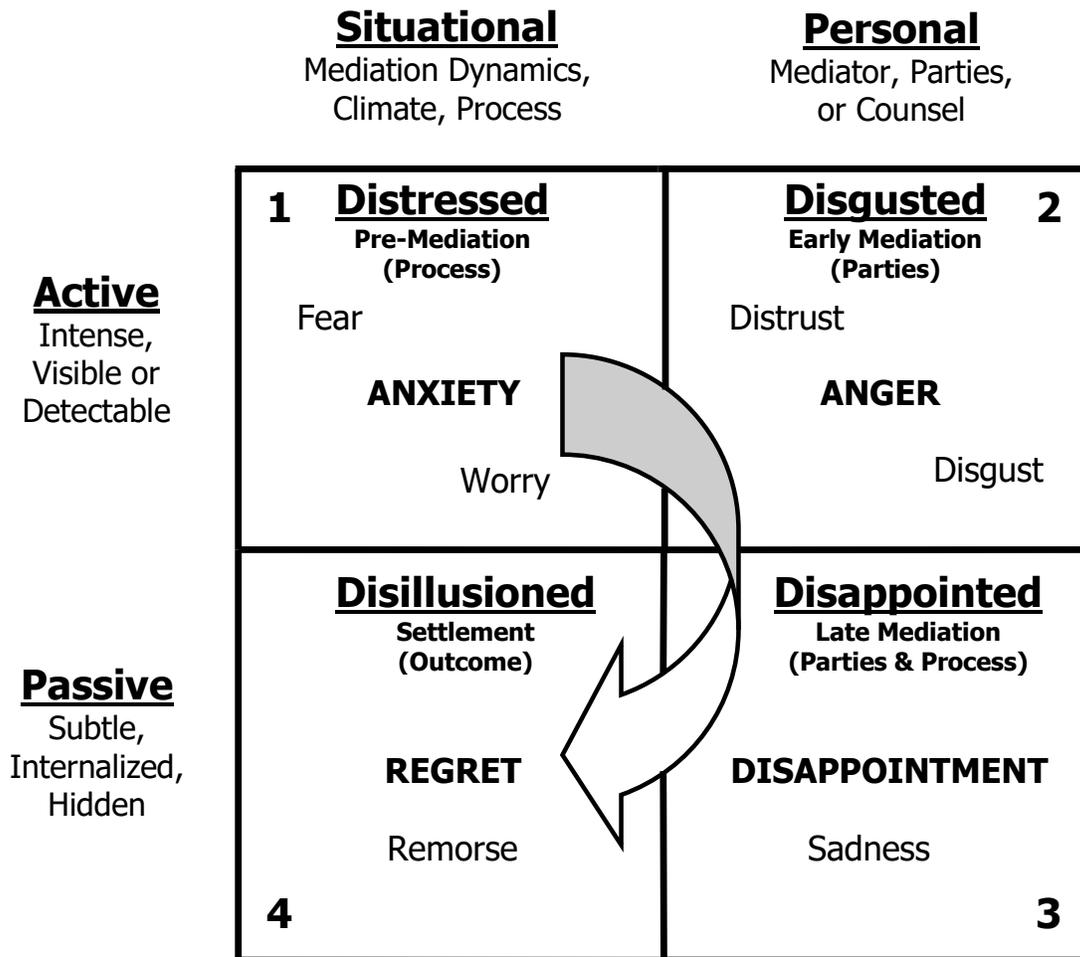
<sup>36</sup> Ibid.

<sup>37</sup> Lieberman, A., The A List of Emotions in Mediation: From Anxiety to Agreement, *Dispute Resolution Journal*, Feb/Apr, 2006, p. 48.

<sup>38</sup> Brooks, A., Emotion and the Art of Negotiation: How to Use Your Feelings to Your Advantage, *Harvard Business Review*, Dec. 2015, p. 59.

<sup>39</sup> Lieberman, The A List of Emotions in Mediation, p. 48.

**Figure 2: Life Cycle Model of Destructive Emotions in Mediation**



**Source:** C.D. Bultena, C.D. Ramser, and K.R. Tilker

more likely to exit negotiations early, and made deals that were less attractive.<sup>40</sup> Other studies revealed that anxious negotiators were less confident; more likely to consult others for advice; less likely to discriminate between good and bad advice; and more likely to be taken advantage of, especially if the other party sensed their distress.<sup>41</sup> Mediators must keep in mind that anxiety is likely to be highest among participants who are new to the process. Such participants also experience fear (they are afraid of the process and afraid to speak) and are worried about the outcome.<sup>42</sup> What can mediators do to arrest the effects of the destructive emotion of anxiety? Mediator coping strategies for destructive emotions at each phase of mediation are presented in Table 3.

<sup>40</sup> Brooks, *Emotion and the Art of Negotiation*, p. 59.

<sup>41</sup> *Ibid.*

<sup>42</sup> Holtz, N., *How the Inside Out of Emotions Affects the Inside of Mediation*, *Alternatives*, Vol 34:1, Jan. 2016, p.3.

### **Quadrant 2 – Disgusted – Early Mediation**

The dominant emotion at this phase of mediation—anger—is potentially the most destructive emotion. This is because of its tendency to escalate into outbursts of rage that can lead to emotional flooding that shuts down one’s ability to function and think clearly.<sup>43</sup> Anger is Personal, focused on the opposing party, counsel, or even the mediator. It is also Active in that it is often intense and one of the most visible emotions. Although it is important to allow parties to vent anger and discuss it, mediators must demonstrate great skill in diffusing it before it escalates to the point of thrusting mediation into a downward spiral.<sup>44</sup> Anger is a valid emotion, but outbursts by attorneys and by participants toward other parties should not be tolerated. As a general rule, anger is not an emotion that will help settle a case.<sup>45</sup> Research by Keith Allred at Harvard indicates that anger harms the mediation process in the following ways: by escalating conflict; biasing perceptions; making impasses more likely; reducing joint gains; decreasing cooperation; and intensifying competitive behavior leading to more rejected offers.<sup>46</sup> Some participants actually fake anger to force their counterparts to give ground in order to diffuse the anger.

Participants in the early stage of mediation are also likely to distrust one another because they often view the dispute as a zero-sum game in which one party’s gain is the other party’s loss. Thus, participants distrust the opposing party’s motives. An even stronger emotion often surfaces in this stage of mediation: disgust, which is complete contempt for the other party. It also is Personal and Active and may be easier to detect than anger. It is usually associated with a facial expression “exhibiting a curled upper lip and wrinkled nose, and sends the simple message that something is offensive in taste or smell, or metaphorically so.”<sup>47</sup> According to Nancy Holtz, disgust arises in mediation when there is “a Grand Canyon between the parties’ views of the case value.”<sup>48</sup> This evokes strong feelings of disgust over the greed of the other party. In most cases, both sides enter mediation with unrealistic expectations of the economic value of their case, and so disgust is a common emotional reaction. Parties need to be reassured at this point so that they do not become disgusted with the entire process and walk out. Mediator coping strategies for these destructive emotions are also outlined in Table 3.

### **Quadrant 3 – Disappointed – Late Mediation**

As mediation winds down, the parties begin to realize that the expectations they brought into the process may not be met. Disappointment and sadness (a sense of loss) begin to set in. They blame themselves, the other party, the mediator, and the whole process for this loss. The focus of their disappointment is still largely Personal, but the emotion in this case is Passive and

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<sup>43</sup> Perry et al., Childhood Trauma, the Neurobiology of Adaptation and Use-Dependent Development of the Brain: How States Become Traits, *Infant Mental Health Journal*, 16(4): 271-291.

<sup>44</sup> Holtz, How the Inside Out of Emotions Affects the Inside of Mediation, p.4.

<sup>45</sup> Ibid.

<sup>46</sup> Allred et al., The Influence of Anger and Compassion on Negotiation Performance. *Organizational Behavior and Human Decision Processes*, 70: 175-187.

<sup>47</sup> Goleman, D., *Emotional Intelligence*, New York: Bantam, 1997, p. 7.

<sup>48</sup> Holtz, How the Inside Out of Emotions Affects the Inside of Mediation, p.4.

so more difficult to detect, “an introspective withdrawal” or giving up that resembles depression.<sup>49</sup> Mediators also experience this disappointment, blaming themselves for participant dissatisfaction. Research indicates “one cause of disappointment is the speed of the process.”<sup>50</sup> Mediation can unfold or conclude too quickly, leaving participants dissatisfied.<sup>51</sup> The solution is to slow down, proceeding cautiously and deliberately. Mediator coping strategies for these destructive emotions are also outlined in Table 3.

#### **Quadrant 4 – Disillusioned – Settlement**

At the conclusion of mediation, the Downward Spiral of Negative Emotions is complete. Participants can feel disillusioned with themselves and the process. If mediation is a chess game, the game was rigged, and they didn’t play well. Disappointment gives way to regret as the dominant emotion. Regret differs from disappointment in that the latter involves sadness about an outcome while regret is “looking a little more upstream at the course of actions that led to this unhappy outcome, and thinking about the missteps or mistakes that created the disappointment.”<sup>52</sup> Participants may blame the mediator, the process, and counsel to some degree, but they also see their own missteps and missed opportunities. The focus of their regret and remorse is Situational, shared by everyone and the process itself. The dominant emotion is still Passive in nature and not as obvious. The greatest losses are the questions that were never asked, the information never obtained, and the missed learning opportunities.<sup>53</sup> A final opportunity to minimize the risk of regret is offered by pursuing a “post-settlement settlement.”<sup>54</sup> Now that an agreement is on the table, spend a few more minutes to see whether there is anything that can sweeten the deal for both sides. Mediator coping strategies for these destructive emotions are also outlined in Table 3.

The negative or destructive emotions that plague mediation at each stage in the process have been explored, and recommendations in Table 3 are offered as vital ways for addressing these emotions, which are sure to enter the process at some point to some degree. The focus now shifts to the cure for destructive emotions in mediation: Emotional Intelligence.

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<sup>49</sup> Goleman, p. 7.

<sup>50</sup> Brooks, *Emotion and the Art of Negotiation*, p. 63.

<sup>51</sup> *Ibid.*

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid.*

<sup>54</sup> *Ibid.*

**Table 3: Strategies to Neutralize Destructive Emotions in Mediation**

<b>Destructive Emotions</b>	<b>Mediator Coping Strategies</b>
<b>Quadrant 1 – Pre-Mediation</b>	
<p><b>Anxiety</b> <b>Fear</b> <b>Worry</b></p>	<ul style="list-style-type: none"> <li>• Talk to the participants about the process and what to expect.</li> <li>• Encourage new participants to be well prepared (the best stress reliever).</li> <li>• Reassuring words, careful explanation, and a little humor go a long way.</li> <li>• Hold pre-mediation meetings, including private caucuses days in advance to educate, set realistic expectations, and get acquainted.</li> <li>• Ask anxious parties to consider hiring a third-party to represent them.</li> </ul>
<b>Quadrant 2 – Early Mediation</b>	
<p><b>Anger</b> <b>Disgust</b> <b>Distrust</b></p> <p><i>“Anger won’t help settle the case!”</i></p>	<ul style="list-style-type: none"> <li>• Allow venting and discussion of anger, but know when to stop. Are you are entering the “black hole,” the downward spiral?</li> <li>• Don’t allow angry outbursts against other parties. Try private caucuses.</li> <li>• Don’t allow attorneys to intimidate parties with angry tirades or posturing.</li> <li>• Build rapport before, during, and after mediation to reduce risk of anger.</li> <li>• Reduce hostility, apologize, keep parties focused on a win-win solution.</li> <li>• Hit Pause button; resist urge to escalate; take a break; cool off; regroup.</li> </ul>
<b>Quadrant 3 – Late Mediation</b>	
<p><b>Disappointment</b> <b>Sadness</b></p>	<ul style="list-style-type: none"> <li>• Use disappointment constructively for critical analysis and improvement.</li> <li>• Use disappointment to diminish defensiveness and promote change.</li> <li>• Slow down the process, proceed cautiously and deliberately to salvage the mediation before final settlement. Proceed more slowly next time.</li> <li>• Help participants set more realistic expectations next time.</li> </ul>
<b>Quadrant 4 – Settlement</b>	
<p><b>Regret</b> <b>Remorse</b></p>	<ul style="list-style-type: none"> <li>• Examine the process for missteps and missed opportunities.</li> <li>• Ask questions, listen, probe, and learn all you can.</li> <li>• Make information important and learning the central goal.</li> <li>• Make sure mediation never ends until every avenue has been explored.</li> <li>• After reaching agreement, explore a “post-settlement settlement.” Can the deal be sweetened for both sides even now?</li> </ul>

**Source:** A compilation of recommendations from the authors, Brooks (2015), Goleman (1997), Holtz (2016), Lieberman (2006), and Smilovitz (2008)

### C. MANAGING NEGATIVE EMOTIONS: EMOTIONAL READINESS AND MEDIATION STYLE

If the downward spiral of negative emotions that leads to failed mediation is to be avoided, both mediator and participants must be aware of these emotions and able to regulate them as well as the behaviors they evoke. Daniel Goleman defines emotional intelligence as “the capacity for recognizing our own feelings and those of others, for motivating ourselves, and for managing emotions well in ourselves and in our relationships.”<sup>55</sup> Emotional Intelligence (EI) involves the ability to tune into and manage one’s own emotions as well as to recognize and respond appropriately to the emotions of others.<sup>56</sup> Goleman views these skills as competencies that can be learned and developed over time.<sup>57</sup> Possessing this ability or emotional competence, however, is not enough to avoid the downward spiral of negative emotions in mediation. Participants must also have emotional initiative, which is the willingness to expend emotional effort in social situations. Thus, participants must be willing (have emotional initiative) and able (have emotional competence) to manage emotions. The extent to which one is willing and able to behave in an emotionally intelligent manner is referred to as emotional readiness.

Hersey and Blanchard (1969), in their classic model, were the first to address readiness of employees in specifying the appropriate leadership style in the Situational Leadership Model.<sup>58</sup> According to the model, leaders must adapt their leadership style to the readiness of their followers, which the authors define as a combination of follower willingness and ability. Each quadrant of this model specifies a different type of leadership response based on the readiness of the participant. This model has been adapted to mediation in the Situational Model of Emotional Readiness and Mediation Style in Figure 3. Participants may enter mediation at any level of emotional readiness. Mediators must be able to recognize their level of readiness and apply the appropriate mediation style to keep the process from being hijacked by destructive emotions. This model prescribes one of four mediation styles for each level of participant emotional readiness. Combinations of high and low levels of emotional competence (ability) and emotional initiative (willingness) define four levels of emotional readiness (Quadrants 1-4). Thus, the model guides mediators in selecting the appropriate mediation style to manage emotions in a given situation. The distinctive Z-pattern of the model suggests a progression through likely stages of emotional readiness over the course of longer mediations or subsequent mediations as participants develop the emotional competencies and initiative to become emotionally inspired “Stars” who can be empowered with far less intervention and direction from the mediator.

#### **Mediation Styles**

From the mediation literature, four distinct mediation styles have been identified: Manipulative, Communicative, Facilitative, and Transformative. The Manipulative Style is an assertive, heavy-handed approach that relies on leverage (power, influence, and persuasion), carrots and sticks, that can be brought to bear at opportune times to move the parties to

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<sup>55</sup> Goleman 98 p.317

<sup>56</sup> Ibid.

<sup>57</sup> Ibid

<sup>58</sup> Hersey, P. & Blanchard, K., Life Cycle Theory of Leadership, *Training and Development Journal*, 23 (5), 26-34.

agreement.<sup>59</sup> This assertive approach is appropriate when the emotional readiness of the parties is low.

The **Communicative Style** is a more passive approach in which the mediator is primarily a broker of concessions who operates as a “passive conduit and repository” of information.<sup>60</sup> Mediators using this style clarify and supply information while also functioning as an intermediary.<sup>61</sup> Their style is to provide and exchange information and offer concessions to move the parties to agreement. This style is well suited to parties with limited emotional intelligence and mediation experience who are willing to negotiate with other parties.

The **Formulative Style** is a more supportive mediation style. Mediators manage the process and facilitate close interaction between parties using great tact and empathy.<sup>62</sup> They clarify and redefine issues and think innovatively to generate creative options for agreement.<sup>63</sup> This style, which requires considerable mediator skill, is best suited for those less willing to negotiate with other parties, and thus requiring more involvement and support from the mediator.

Finally, the newest concept in mediation is the **Transformative Style**.<sup>64</sup> Here the mediator offers support and allows the parties to structure both the process and outcome of mediation.<sup>65</sup> The aim is to transform the relationship and to allow the parties to determine their own fate. Parties usually meet in joint session, mediators empower the parties as much as possible, and each party recognizes the needs, interests, values, and point of view of the others.<sup>66</sup> It is the most autonomous mediation style and is reserved only for parties with the highest level of emotional readiness. The following sections describe the four levels of participant emotional readiness and the appropriate mediation style (Quadrants 1-4). Also offered is a cartoon caricature to exemplify the nature of participants in each quadrant of the model.

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<sup>59</sup> Touval, S. & Zartman, I., *International Mediation in Theory and Practice* (Boulder CO: Westview, 1985), p.12.

<sup>60</sup> Ibid., p. 11-12.

<sup>61</sup> Ibid.

<sup>62</sup> Ibid., p. 127

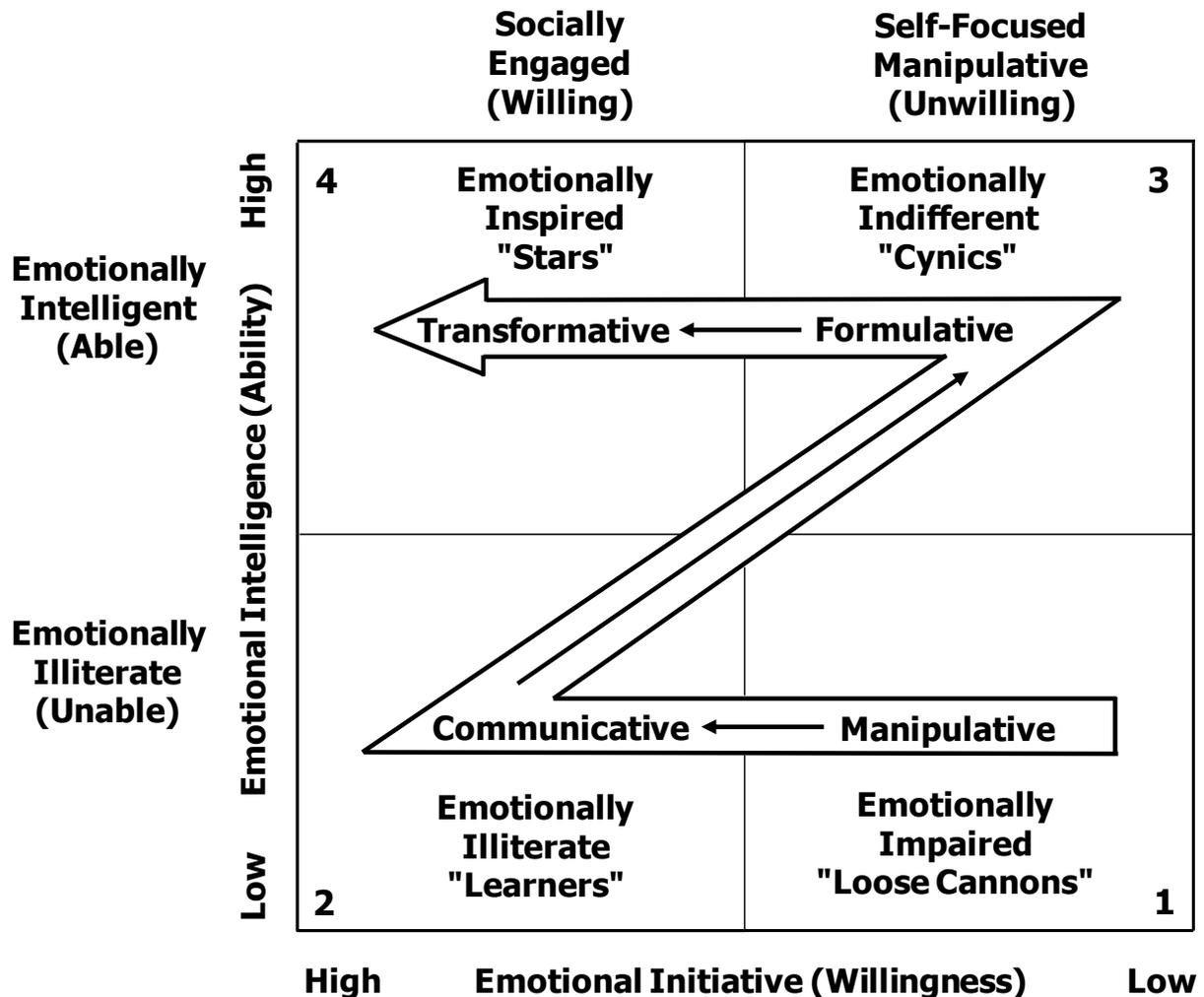
<sup>63</sup> Ibid.

<sup>64</sup> Bush, R. & Folger, J., *The Promise of Mediation*, Jossey-Bass, 1994.

<sup>65</sup> Zumeta, Z., *Styles of Mediation: Facilitative, Evaluative, and Transformative Mediation*, <http://www.mediate.com/articles/zumeta.cfm> (last visited May 20, 2016) lead author retains a copy.

<sup>66</sup> Ibid.

**Figure 3: Situational Model of Emotional Readiness and Mediation Style**



**Source:** Adapted from Bultena and Hutton (2007) to mediation.<sup>67</sup> Dimensions of participant readiness (willingness and ability) adapted from Hersey and Blanchard (1969).<sup>68</sup>

**Quadrant 1 – Emotionally Impaired – “Loose Cannons”**

These participants are called “Loose Cannons” because they are emotionally impaired, unable (possess few emotional intelligence skills) and unwilling to expend emotional effort in social settings (low in emotional initiative). *Anger*, the flaming character in Disney’s animated blockbuster *Inside Out* who blows his top anytime he is upset, is a good caricature of this participant. The behavior of these participants is unpredictable in mediation. Because they lack social skills and social initiative, they are unlikely to cooperate with mediation parties and

<sup>67</sup> Bultena, C., & Hutton, B., Emotional Intelligence and Leadership Style: A Situational Approach, *Journal of Business and Behavioral Sciences*, 15(1), 2007, p. 44.

<sup>68</sup> Hersey, P. & Blanchard, K., Life Cycle Theory of Leadership, *Training and Development Journal*, 23 (5), 26-34.

unlikely to temper negative emotional responses. They may also engage in faking emotions, especially anger, to intimidate and gain advantage over other participants. A Manipulative Style that is directive and assertive is required to detect faking, manage destructive emotions, and keep the parties moving toward agreement. Mediators should acknowledge anger and allow venting to a point, but angry outbursts directed toward the other party in joint session can be devastating.<sup>69</sup> Anger, as a general rule, is not an emotion that will help settle a case.<sup>70</sup>

### **Quadrant 2 – Emotionally Illiterate – “Learners”**

These participants are unable in that they possess few of the competencies associated with emotional intelligence. They lack training in these competencies; they are emotionally illiterate. Nevertheless, they are enthusiastic and willing to expend emotional effort in social settings. They have high emotional initiative. They are called “Learners” because, despite their lack of emotional intelligence skills, they are good-natured, sincere and willing to learn and cooperate. *Olaf*, the snowman in Disney’s animated hit *Frozen*, is an iconic image of this participant. He makes a lot of unintentional mistakes, but he’s sociable and loves warm hugs. Because these participants are more cooperative and less likely to battle it out with strong emotion, they are more likely to respond to a Communicative Style, in which the mediator acts as an intermediary and a teacher sharing and clarifying information while offering concessions to keep the parties moving toward agreement.

### **Quadrant 3 – Emotionally Indifferent – “Cynics”**

These participants are able in that they have developed emotional intelligence skills, but they are self-focused and unwilling to expend emotional effort to reach out or cooperate with other parties. They lack emotional initiative. They are called “Cynics” because although they are able to keep negative emotions in check, they are self-focused and can be indifferent, even manipulative, in relating to other parties in mediation. They are capable of deception or faking emotions in order to bolster their position. Before settling down to Elastigirl, Pixar’s *Mr. Incredible* exemplified the Cynic in his famous line, “I Work Alone!” One super power he did not possess was emotional initiative. To break down emotional barriers and limit the potential for gamesmanship among Cynics, mediators must adopt a more supportive Formulative style.

### **Quadrant 4 – Emotionally Inspired – “Stars”**

Reaching a mutually acceptable settlement is greatly enhanced when “Stars” are present in the mediation room. These participants have reached the pinnacle of emotional maturity. They have well-developed emotional intelligence skills (ability), and they have the emotional initiative (willingness) to apply them. Like *Superman*, they have all the tools they need to excel in mediation. This is a rare opportunity to engage in Transformative Mediation, whereby participants are empowered to manage the process and outcome of mediation themselves to determine their own fate. Mediators must, however, resist the temptation to micro-manage the process in this case.

<sup>69</sup> Holtz, N., How the Inside Out of Emotions Affects the Inside of Mediation, *Alternatives*, Vol. 34:1, Jan. 2016, p.4

<sup>70</sup> Ibid.

#### D. *RECOMMENDATIONS FOR MEDIATION AND MEDIATION PARTICIPANTS*

Emotions are intricately woven into the fabric of human behavior and human conflict. While positive emotions are the key to success in most human endeavors, negative emotions are the squeaky wheel that gets the grease. Strong negative emotions, such as anxiety, anger, fear, disappointment, sadness and regret, are common and can be destructive in mediation. Yet few mediators and participants are well-versed in how to cope with these destructive emotions when they arise. The models presented in this paper alert mediators to the process by which emotions escalate, giving them the opportunity to arrest them. The models also identify the phases of the mediation process in which these destructive emotions are most likely to surface, providing specific guidance on how to counteract them as mediators navigate the emotional fog. Finally, they adapt the idea of emotional intelligence to mediation as a means of matching the appropriate mediation style to the emotional maturity or readiness of participants. Applying the wrong style (e.g., using the Transformative style when dealing with “Loose Cannons”) unleashes the very destructive emotions the Life Cycle Model of Destructive Emotions in Mediation is designed to address. The models presented in this paper are useful as both diagnostic and prescriptive tools to guide mediators seeking to manage the complex dynamics of emotions in mediation.

Mediation training, which historically has de-emphasized the emotional component of mediation, must be recalibrated. Emotions are an integral part of conflict and of conflict resolution. With proper training, mediators can unlock emotional barriers that may be blocking resolution of some cases. In many instances, merely acknowledging hurt feelings or disrespect can put the process back on track. Training should not stop with mediators. Participants and their counsel may also lack the skill (emotional intelligence) to navigate the emotional landscape.

Another issue in many cases is the domination of mediation parties by counsel. Most participants are new to mediation, often attending their first session. Apprehension and fear of the process compels them to hire counsel or, in many cases, to hire counsel as a defensive measure because the other party is represented. Over-reliance on counsel can distance the participants from mediation, which is intended to be a collaborative process. Because interaction between the parties is one step removed, distant, and indirect, it is less likely that the real emotional issues will ever surface or be resolved. Less reliance on counsel is an important first step toward changing that dynamic.

Finally, court-ordered mediation is creating “Mediation Mills” that employ what we call “Microwave Mediation” to trash and bash out hundreds of settlements each month at lightning speed. Research indicates that the rush to settlement is a major cause of disappointment among parties.<sup>71</sup> Mediation often unfolds or concludes too quickly, leaving participants dissatisfied.<sup>72</sup> Destructive emotions are not addressed at lightning speed. If mediators are to address the detrimental impact of strong emotions on mediation, some traffic lights or at least a few yield signs are in order to arrest speeding on the mediation superhighway.

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<sup>71</sup> Brooks, *Emotion and the Art of Negotiation*, p. 63.

<sup>72</sup> *Ibid.*

## VI. SUMMARY

To date, little has been done to address the impact of destructive emotions in mediation. This paper attempts to fill the gap by applying new models to aid mediators and parties in this endeavor. First, the operation of emotions and how they escalate was explored in the Continuum of Emotional Escalation in Figure 1. Then, the Life Cycle Model of Destructive Emotions in Mediation was created in Figure 2 to classify ten key destructive emotions in terms of their focus, manifestation, and where they are likely to strike in the mediation process. Specific coping strategies were provided in Table 3 to guide mediators in countering the destructive effects of each emotion. Finally, Emotional Intelligence was applied to the field of mediation in the Situational Model of Emotional Readiness and Mediation Style in Figure 3, which allows mediators to match the appropriate mediation style to the emotional maturity of participants. Finally, a comprehensive plan to address destructive emotions in the larger arena of mediation practice was presented. This plan includes a proposal to improve training of mediators, counsel, and participants, to restore traditional, collaborative, and direct party interaction in joint session, to curb the use of attorneys and indirect negotiation, and to slow the frantic pace of “Microwave Mediation,” which leaves many parties dissatisfied.

## VII. SUCCESSFUL MEDIATION IN BUSINESS

While there is room to improve mediation through application of the interpersonal tools presented in this paper, there is little doubt that mediation has become a highly effective mechanism for conflict resolution. The significance of the process can be seen in the large number of cases in Texas and Oklahoma, the rapid growth in the number of cases in Nebraska, and the impressive settlement rates seen in the region. These impressive regional settlement rates are mirrored across the United States and internationally. Thus, the widespread use of mediation and its potential for cost-effective conflict resolution are well-established. Beyond the numbers, however, mediation’s success is also evident in the wide variety of cases settled, not to mention the many cases that do not reach full settlement yet narrow the differences to be subsequently resolved through arbitration or litigation. As shown in Table 4, successful mediation has occurred in a broad range of conflict situations, varying greatly in both the size and nature of the dispute. Cases range from massive corporate cases such as the crash of Swissair Flight 111 to small domestic disputes involving handyman repair charges. Table 4 also highlights the variety of issues involved in mediation, varying from suits over passenger deaths, age and gender discrimination, malpractice, and whistleblowing to control over Native American tribal councils, bullying among 10 year old girls, attacks on college students, and moving sand between coastal islands. Overall, the increasing volume, variety, and scope of mediation cases highlight its expanding role in business and society.

## VIII. CONCLUSION

The success of mediation and its application across a spectrum of conflict situations have been noted, the problem of destructive emotions has been exposed, and several tools to help mediators and participants respond appropriately to ensure success in mediation have been supported. Business leaders can use these tools to address the problem of negative emotions among mediation participants, thus leading to greater harmony and more success in the process. Mediation need not be a maddening process. It is most likely to succeed when participants recognize and respond appropriately to negative emotions in the process.

The volume, variety, and settlement rates of mediation cases suggest a bright future for this form of conflict resolution. With the use of mediation on the rise, it is more important than ever for business leaders to master skills necessary to take full advantage of the opportunities this process offers. Mediation is an effective tool when business leaders prepare for and navigate the process with a clear understanding of how to remove interpersonal barriers, thus ensuring more understanding, mutual respect, and open communication.

## Table 4: Examples of Successful Mediation in Business

### **Cases Mediated by Bruce Meyerson<sup>73</sup>**

- A dispute between two real estate agents over a commission.
- A legal malpractice case arising from a divorce settlement.
- A claim of disability discrimination by a health care worker with the HIV virus.
- Claims by a group of home owners of construction defects due to expansive soil.
- An ERISA suit over the denial of disability benefits.
- A dispute among companies over payments under a personal injury settlement.
- A claim of national origin and gender discrimination.
- A claim of age discrimination against a large health care provider.
- A dispute among factions seeking control of a Native American tribal council.

### **Major Cases Mediated by JAMS<sup>74</sup>**

- Retired Judge Diane Welsh mediated claims by passengers of Swissair Flight 111; accidents involving private planes; and a plane crash into a residence.
- Successfully mediated hundreds of business disputes involving breach of contract, corporate franchise, licensing, partnership, shareholder's rights, and breach of warranty.
- Mediated high-profile copyright claims by songwriters against record producers and breach-of-contract claim by a heavyweight boxing champion against a promoter.

### **Cases Mediated by NAFCM (National Association for Community Mediation)<sup>75</sup>**

- Tenant harassment and abusive conduct toward an elderly landlord.
- Homeowner who lives next to a church disturbed by late-night janitorial service.
- Abuse and bullying of 10-year-old by next-door neighbor's daughter.
- Homeowner dispute with a handyman over additional charges for redwood dry rot.

### **Notable U.S. Mediation Cases – Mediate.com<sup>76</sup>**

- Mediation prevents closure of the only hospital in Pawnee County, Kansas.
- A town reaches agreement with a former secretary who won a whistleblower case to split the cost of the \$1.3 million settlement between the town's insurance and the town budget.
- Mediation between homeowners of two islands and a local Florida government over where beach replenishment sand from dredging Destin harbor was to be placed.
- Mediated settlement over a racially motivated attack on three Asian college students by four attackers and the need to publicize consequences to deter similar behavior.

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<sup>73</sup> Bruce Meyerson, *Examples of Cases Mediated*, <http://www.brucemeyerson.com/arizonamediationservices.html> (last visited May 20, 2016) lead author retains a copy.

<sup>74</sup> JAMS Arbitration, Mediation and ADR Services, *News, Events, and Publications*, <http://www.jamsadr.com/welsh> (last visited May 20, 2016) lead author retains a copy.

<sup>75</sup> NAFCM National Association for Community Mediation, *Mediations Success Stories*, [http://www.nafcm.org/?page=Success\\_Stories](http://www.nafcm.org/?page=Success_Stories) (last visited May 20, 2016) lead author retains copy.

<sup>76</sup> Mediate.com, *Notable Mediation Cases from Around the U.S.*, <http://www.mediate.com/articles/notable.html> (last visited May 20, 2016) lead author retains a copy.



## **SOCIAL MEDIA: CREATING STUDENT AWARENESS OF ITS USE IN THE HIRING PROCESS**

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### *Abstract*

*As the use of social media permeates our lives, it is important for business educators to promote the effective use of this technology to students for both their role as job seekers as well as potential hiring managers. This article will present current perceptions among business students on using social media in the job search process, primary research from recruiters in an attempt to understand employers' policies and practices with respect to the use of social media in the hiring process, key laws which students should be aware of with respect to the use of social media by employers, and practical guidance for students throughout their business school experience. In addition, a proposed teaching method will be presented on how to convey this practical guidance to students in a compelling and impactful manner.*

Keywords: Social media, job search, business education, employment law

## INTRODUCTION

Social media is ubiquitous and is now commonly being used in the job search and employee selection processes. Social media sites like Facebook, Twitter, Pinterest, and others were first used to connect people online to stay in touch and share ideas; however, this has changed as “companies are not only using social networks to market their companies and brands, but also are using social networks as a tool in their employee recruitment, screening, and selection processes.”<sup>1</sup> As the use of social media continues to permeate our lives, it is important for business educators to promote the effective use of this technology to students in preparation for both their role as job seekers as well as potential hiring managers.

The prevalence of the use of social media is apparent in a 2014 Jobvite survey, where 93% of recruiters stated they either currently use or plan to use social media in their recruitment efforts.<sup>2</sup> The most common site used by businesses is LinkedIn.<sup>3</sup> According to recruiters, LinkedIn is used for searching for candidates (95%), contacting candidates (95%), and vetting candidates before an interview (93%).<sup>4</sup> Additionally, Jobvite reports that more than 90% of organizations use LinkedIn to monitor potential job candidates (93%) or post jobs (92%).<sup>5</sup>

There are numerous benefits derived from organizations using social media for employee recruitment purposes. Social media provides quick access to a large amount of unfiltered information on candidates. Using social media, recruiters can examine an applicant’s professional experience, tenure, hard skills, cultural fit, and interaction in the industry through the applicant’s posts.<sup>6</sup> According to Jobvite, 55% of companies have reconsidered a job candidate based on what they saw online about the candidate.<sup>7</sup> This online information can help employers to better engage with their target audience and identify individuals who would be a good fit with the organization.<sup>8</sup> Social media sites also build brand awareness, which can be influential in the recruitment process.<sup>9</sup> In addition, social media can aid in diversity efforts by allowing the company to share information about itself to a broad audience to attract a more diverse applicant pool.<sup>10</sup> Such efforts can also help attract passive candidates who are not actively seeking new employment but might be open to new opportunities.<sup>11</sup>

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<sup>1</sup> Teri Root & Sandra McKay, *Student Awareness of the use of Social Media Screening by Prospective Employers*, 89 J. EDUC. FOR BUS. 202, 202 (2014).

<sup>2</sup> *Social Recruiting Survey Results*, JOBVITE, [http://1u7p3g2igrbh4643ym2ty7va.wpengine.netdna-cdn.com/wp-content/uploads/2012/08/Jobvite\\_SocialProfilesHelpKFFINAL33.png](http://1u7p3g2igrbh4643ym2ty7va.wpengine.netdna-cdn.com/wp-content/uploads/2012/08/Jobvite_SocialProfilesHelpKFFINAL33.png) (last visited Feb. 9, 2016).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> See *Social Recruiting Survey Results*, *supra* note 2.

<sup>7</sup> *Id.*

<sup>8</sup> See Irina Nagy, *The Benefits of Social Media Recruiting*, ONREC: THE ONLINE RECRUITMENT RESOURCE (Aug. 29, 2013), <http://www.onrec.com/news/news-archive/the-benefits-of-social-media-recruiting.I>.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*, see also Laura Sewell, *Passive Candidates: Who They Are and How to Find Them*, NET-TEMPS, <http://www.net-temps.com/recruiters/recart/printer.htm?id=27> (last visited Feb. 9, 2016) (“A passive candidate is someone who is not looking for a job, but would be open to taking one if the right opportunity came along.”).

While it is evident that organizations use social media for recruitment and selection of job candidates on a regular basis, organizations' use of social media must comply with various employment laws.<sup>12</sup> Technological and societal development frequently outpace that of the law, and thus it is not always clear how existing employment laws apply to the use of social media.<sup>13</sup> A critical legal and ethical issue with respect to the use of social media in the hiring and employment process is when its use will violate employment discrimination laws.<sup>14</sup> As more and more of our lives are lived out online, employers find themselves with access to more information on job candidates and employees than ever before, much of which could potentially be used in a discriminatory manner.<sup>15</sup>

As anti-discrimination laws are designed to protect both current employees as well as applicants, it is imperative that business instructors across multiple disciplines teach students not only how to use social media responsibly and ethically (as future business professionals), but also about their own legal rights with respect to the use of their social media profiles in the employment process. However, this can be difficult, as students' perceptions of what information about them is available online as well as how employers may use this information can differ widely from that of employers. Thus, students need to be taught not only what the black letter law in this area is, but also the practical realities of how their social media use can affect them now and in the future.

This article will address this problem in four parts. First, studies on the current perceptions among business students on using social media in the job search process will be discussed. In part two, original research conducted by the authors with on-campus student recruiters as well as other large companies in an attempt to ascertain employers' policies and practices with respect to the use of social media in the hiring process will be covered. In part three, key laws which students should be aware of with respect to the use of social media by employers will be explained. Part four will conclude with practical guidance which needs to be provided to students throughout their business school experience in order to help them cope with the potential impact their online presence can have on their search for employment and future careers. This section will also propose a teaching method for how to convey this practical guidance to students in a compelling and impactful manner.

## **I. STUDENT PERCEPTIONS OF SOCIAL MEDIA USE IN THE EMPLOYMENT PROCESS**

One would assume that today's students, who are heavy users of social media, would expect to use these same tools in their future job search. However, an informal poll conducted in

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<sup>12</sup> See Jordan M. Odo, 19-MAR HAW. B.J. 6, 7 (2015) (discussing how social media in the hiring process interacts with employment discrimination laws).

<sup>13</sup> *Id.* at 6-7 ("As will be discussed below, social media's expansion of the workplace has greatly exacerbated issues of privacy, discrimination, harassment, and bullying. Meanwhile, the law in these areas is largely underdeveloped and ambiguous, leaving employees and employers uncertain about their rights and obligations.").

<sup>14</sup> See Scott Brutocao, *Issue Spotting: The Multitude of Ways Social Media Impacts Employment Law and Litigation*, 60 THE ADVOC. (TEXAS) 8, 8 (2012) ("Employers, meanwhile, must be just as cautious of using social media during the employment process; an employer's knowledge of an employee's information available on social media sites provides fertile ground for potential plaintiffs to support discrimination, retaliation, and other employment related claims.").

<sup>15</sup> *Id.* ("Although the employer may gain useful information about the candidate that informs the hiring decision, what would otherwise be a manager's innocent search could uncover information about a candidate's race, religion, or other protected class that employers are barred from using in the hiring process.").

a university-level business communications class by one of this article's authors found that students were unsure if they would use it in their future job searches. In this poll, 35% of students stated they probably would use social media, whereas 35% stated they would not use it. In contrast, when the same students were asked if they thought potential employers would look at their social media sites when considering them for a job, 82% responded affirmatively. Anecdotally at least, there seems to be a disconnect in how students perceive the role of social media in the job search process.

More formal studies support this informal evidence. One study of university students that investigated their perspectives on what potential employers looked for on social media sites indicated that students believed employers were likely to check Facebook profiles.<sup>16</sup> The students stated they were not likely to post anything on personal sites they would not like an employer to view.<sup>17</sup> However, the findings from the study indicated students did not fully understand the impact of less direct information available about them on social media.<sup>18</sup> The study suggested that students were not likely to understand the importance of written communication skills outside of classroom assignments, and thus would not be aware that employers might interpret writings found on social media sites as indicative of their communication skills.<sup>19</sup> Students were also unaware that their associations with groups and other individuals on social media may be used as part of the assessment of a candidate for the position.<sup>20</sup> Thus, Root and McKay recommended that the importance of an effective social presence needs to be conveyed to students early in their studies so that students will begin to establish a positive social media presence early and build on this throughout their college career.<sup>21</sup>

While students may have knowledge that prospective employers are likely to review their social media presence during the hiring process, another study indicates that students may not fully appreciate what employers believe they can learn about an applicant from their social media presence.<sup>22</sup> In their study, the authors surveyed 435 college students regarding their social media use and awareness of employers' use of social media in the hiring process.<sup>23</sup> Of these students, 143 volunteered for a second phase of the research project, which involved having a team of human resource professionals review their Facebook pages.<sup>24</sup> The results of this research project revealed an interesting gap between student and employer perceptions of what could be learned about a candidate on social media.<sup>25</sup>

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<sup>16</sup> See Root & McKay, *supra* note 1, at 204 (“Nearly 80% of the respondents felt that prospective employers were either likely or very likely to check Facebook for applicants’ profiles.”).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 205 (noting, for example, that students were unaware that “many hiring professionals consider which groups students belong to and what others post to their profiles to be important reflections of a candidate.”).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 206 (discussing that social media presence “should be addressed early in a student’s academic career. For that matter, these issues should really be raised in K-12 concepts.”).

<sup>22</sup> See Michael J. Curran, et. al., *College Students and HR Professionals: Conflicting Views on Information Available on Facebook*, 24 HUM. RESOURCE MGMT. J. 442, 450 (2014) (“There is a significant difference between what college students perceive someone could learn about them using social media and what HR professionals believe they actually do learn.”).

<sup>23</sup> *Id.* at 445.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 450.

A majority of the students displayed awareness of employer use of social media, as 60.3% answered that potential employers “probably” or “certainly” would use social media to screen applicants.<sup>26</sup> However, the survey respondents were also confident that their own Facebook page was not problematic in this regard, as 76.1% of the students responded that they were “fairly” or “completely” comfortable that a potential employer would use their Facebook page to screen for employment.<sup>27</sup> When asked specific survey questions about what an observer could learn about the student from their Facebook page in eleven areas, including political orientation, sexual orientation, drug and alcohol use, and unethical behaviors, students indicated that they believed employers could learn relatively little about them based upon what they had placed on Facebook.<sup>28</sup> The researchers used a 5 point scale ranging from 5 (“a substantial amount of information”) to 1 (“nothing”) for each item on the survey, and only three of the categories (sexual orientation, relationship status, and hobbies) had a mean score from the students of over 3.0.<sup>29</sup> Furthermore, in six of the categories (political affiliation, alcohol/drug use, economic status, religion, unethical behaviors, and work habits), the students reported a mean score of less than 2.0.<sup>30</sup> Thus, while the students appeared to be aware that their Facebook pages would be viewed by potential employers, their survey response indicated a general belief that the information these prospective employers could glean from their Facebook page was quite limited.

When the student Facebook pages were reviewed by a team of human resource professionals, the results were quite different. On each of the eleven categories, the human resource professionals rated the information they learned from Facebook higher than the students did.<sup>31</sup> The researchers found that this difference was statistically significant for all of the categories except one – hobbies and leisure activities.<sup>32</sup> Perhaps the most troubling aspect of these survey results was that for categories that employers most often cite as important (unethical behaviors, work habits, alcohol use, and communication skills), students tended to score the information available as relatively low while the human resource professionals tended to score the information available as relatively high.<sup>33</sup>

This research indicates that there is a fundamental disconnect between students’ perception of how an employer would view them based upon social media and the impression actually being made on employers. Notably, the error could be attributable to either or both parties. It is possible, or even probable, that students do not fully understand the impact of the information they are sharing online. However, it is also possible, or even probable, the human resource professionals are overestimating their ability to ascertain information about a person simply from viewing his or her Facebook profile. For business school educators, this disconnect creates an important educational opportunity to prepare students as both job candidates and future hiring professionals.

## II. EMPLOYER PRACTICES AND POLICIES WITH RESPECT TO SOCIAL MEDIA USE

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<sup>26</sup> *Id.* at 446.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 450

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 451.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 452.

As shown in the Curran study, students seem to lack understanding of how their online presence can impact their job search or how much information companies can glean from their social media presence.<sup>34</sup> In order to better determine how companies utilize social media in the hiring process, three of the authors of this article aimed to gather primary data from corporate recruiters involved in on-campus recruiting.

Two rounds of data collection were attempted. The first was conducted late in the fall 2014 semester and early in the spring 2015 semester. Approximately 200 companies that participated in career fairs at one regional university in the southern part of the United States were sent a survey link by the Career Services department as part of a follow-up email after the career fair. In the 2014 – 2015 year, there were three career fairs included in this study: one in October, another in December, and a final one in March. A total of twenty-five completed surveys were received. There was diversity in industry, but a majority of respondents (62%) were in the education sector. Other industries represented include finance and insurance (9%), professional, scientific and technical services (5%), healthcare and social assistance (5%), and other services (19%). In addition, there was diversity in the age and job titles of participants. Respondents reported ages from “under 30” (29%) to “60+” (12%). Managers, directors, and assistant directors/managers were included in this study as well.

When the participants were asked if their company had a policy about the use of social media or internet searches in the hiring process, 44% said no and 39% responded yes. Seventeen percent of the respondents were not sure if their company had such a policy. Half of the respondents (50%) reported that their company “sometimes” checked an applicant’s social media site(s), while 22% said their company “never” checked the sites. Six percent responded “rarely,” 17% indicated the sites were “often” checked, and 5% said social media sites were checked “very often.”

The survey also included a question to investigate the motivations behind checking an applicant’s social media presence. Responses included looking for cultural fit with the organization, “to determine if the applicant has tasteful and professional use of social media,” and to “learn more about the person outside of the professional interview setting.” Similarly, survey participants were asked about the benefits of using information that is available online (not limited to social media sites) in the hiring process. The easy availability of the information was highlighted. In addition, it was mentioned that doing so “gives a more complete picture of a candidate.” Another participant noted that using information that is available online allows for information to be gathered “...that otherwise would likely not be discovered in a standard interview process.”

While the benefits of reviewing social media sites, as well as information posted on the Internet, were highlighted, survey participants were also asked about the challenges of using such information in the hiring process. The accuracy of information was noted by respondents, as evidenced by the comments “information may not be accurate” and “unable to find the exact candidate.” In addition, another respondent noted “remaining objective and not crossing a discriminatory line” was a challenge of using the information online.

In an effort to obtain more survey responses, a second round of data collection was attempted late in the spring of 2015 by posting the survey link on recruitment and hiring groups on LinkedIn. However, only seven completed responses were received. Although it is unknown

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<sup>34</sup> *Id.* at 452 (“This study demonstrated a strong disconnect between the perceptions of college students and those of HR professionals regarding the amount of information available when viewing a Facebook page.”).

why the response rate for this survey was so low, the authors question whether recruiters may be reluctant to disclose their use of social media. This may be because organizations do not have formal policies or that organizations are wary of establishing guidelines on social media's proper use because the legal landscape with respect to the use of social media in the workplace is still somewhat unclear.<sup>35</sup>

If companies do not have clear guidelines on its use, it could be questionable about how social media is being used to screen applications within a particular company. One survey respondent commented "We do not have a formal policy outlining social media used in hiring. We do have policy regarding employees [*sic*] and company use of social media." Additionally, if the use of information available on social media varies from candidate to candidate within a company, there could be internal concerns about claims of discrimination. Regardless, students should be aware of the diverse use of social media in hiring decisions. They should also be presented with guidelines on standard things to avoid posting on social media. With a seeming lack of policies on its use, using social media in the hiring process brings into question what exactly job seekers should be concerned about. A primary concern that needs to be addressed is the risk for discrimination.

### III. ONLINE INFORMATION AND EMPLOYMENT DISCRIMINATION

Since social media is commonly being used through the recruitment and hiring process, it is imperative that students are taught the legal and ethical implications of its use while in business school. This is important so they are aware of their rights as an employee when seeking employment and so that they use social media wisely before beginning the job search process. Additionally, since many business students will eventually be in the position of making hiring decisions in their business careers, they need to be aware of the law regarding the social media information that they can and cannot consider. While there are various legal issues which may arise with respect to the use of social media in the workplace, this section will focus on the key legal issue of anti-discrimination laws and their interaction with the use of social media in the employee recruitment and selection process.

Under Title VII of the Civil Rights Act of 1964, it is unlawful for employers to make employment decisions, including hiring decisions, based upon a person's membership in certain protected classes.<sup>36</sup> These federally protected classes are race, color, religion, sex, and national origin.<sup>37</sup> While age is not considered a protected class under the Civil Rights Act, the Age Discrimination in Employment Act also prohibits discrimination based upon age for workers that are forty years of age or older.<sup>38</sup> Additionally, the Americans with Disabilities Act prohibits employment discrimination against individuals with disabilities.<sup>39</sup>

Some states have included additional classes of individuals which cannot be discriminated against. This includes so-called "lifestyle discrimination" statutes passed by some states which prevent employers from discriminating against employees based upon lifestyle

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<sup>35</sup> See Odo, *supra* note 12, at 7 (noting how the law regarding some uses of social media in the workplace is still underdeveloped).

<sup>36</sup> 42 U.S.C. § 2000e-2 (2015).

<sup>37</sup> *Id.* § 2000e-2 (a) (1) & (2) (listing the classes protected against discrimination in employment as "race, color, religion, sex, or national origin").

<sup>38</sup> 29 U.S.C. § 623 & 631 (2015).

<sup>39</sup> 42 U.S.C. § 12112 (a) (2015).

choices, such as hobbies, as long as such lifestyle choices are lawful.<sup>40</sup> For example, the state of Colorado has an anti-discrimination statute which makes it illegal to discriminate in employment based upon “the employee’s engaging in any lawful activity off the premises of the employer during nonworking hours” unless the activity is restricted by the employer because it is related to the employee’s employment responsibilities or otherwise conflicts with employment.<sup>41</sup> As an example of an application of this statute, a Colorado attorney was successfully able to sue for discrimination after he was discharged from his firm because he was a homosexual.<sup>42</sup> The court reasoned that engaging in a homosexual relationship was a lawful activity which occurred off the premises of the employer, and thus could not be used as a basis for an employment decision under this Colorado law.<sup>43</sup> The state of New York has similar legislation which prevents discrimination based upon lawful political activities, legal use of consumable products, and legal recreational activities.<sup>44</sup> Statutes such as these cast a much broader net than federal anti-discrimination laws, and prevent employers from making employment decisions for information found on social media related to lawful activities such as alcohol use or personal relationships. While students and employers in these jurisdictions must be aware of these unique laws, because these statutory requirements can vary significantly by state this article will focus on federal anti-discrimination statutes applicable to all states.

Under federal anti-discrimination law, there are two broad legal theories under which a discrimination claim can be brought – disparate treatment and disparate impact.<sup>45</sup> Disparate treatment is the most blatant form of discrimination and is typically easily recognizable – it is intentional discrimination where the employer engages in some employment practice with the motive of discriminating based upon membership in a class that is legally protected.<sup>46</sup> The hallmark of disparate treatment discrimination is that it is intentional.<sup>47</sup> Thus, for example, simply intentionally refusing to promote women to certain managerial positions would be disparate treatment discrimination.

Disparate impact discrimination involves an employment policy that appears neutral and is implemented without the intent to discriminate, but nevertheless has a disproportionate effect on members of a protected class.<sup>48</sup> The quintessential example of such a policy is found in the

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<sup>40</sup> See Stephen D. Sugarman, “Lifestyle” Discrimination in Employment, 24 BERKELEY J. EMP. & LAB. L. 377, 431-33 (2003) (discussing legal protections that have been provided in some jurisdictions for so-called “lifestyle” discrimination).

<sup>41</sup> COLO. REV. STAT. § 24-34-402.5 (2015).

<sup>42</sup> See *Borquez v. Robert C. Ozer*, P.C. 923 P.2d 166, 171 (Colo. App., Div. 1 1995) (affirming the jury’s finding of wrongful discharge under the Colo. Rev. Stat. § 24-34-402.5 where the discharge was due to engaging in a homosexual relationship).

<sup>43</sup> *Id.* at 171 (“Next, we reject defendants’ assertion that the jury verdict was based upon Borquez’ *status* as a homosexual, rather than upon his conduct and, therefore, that there was no lawful *activity* in which Borquez was engaged during his off-work hours that could have been the basis for his discharge. The jury was presented with evidence that Ozer particularly object to Borquez’ sexual relationship during his off-work hours.”).

<sup>44</sup> N.Y. LAB. LAW § 201-d (2) (a) – (d) (McKinney 2015).

<sup>45</sup> See Richard Primus, *The Future of Disparate Impact*, 108 MICH. L. REV. 1341, 1351 (2010) (discussing the two legal theories of disparate treatment and disparate impact discrimination)

<sup>46</sup> *Id.* (discussing disparate treatment discrimination and noting that it covers discrimination where there is an “illicit employer motive”).

<sup>47</sup> *Id.* (“The discrimination is intentional, and intentional discrimination is called ‘disparate treatment.’”) (internal footnote omitted).

<sup>48</sup> See Deborah A. Widiss, *Griggs at Midlife*, 113 MICH. L. REV. 993, 1010 (2015) (noting that disparate impact discrimination involves “a facially neutral policy that is implemented without any ‘intent’ to discriminate but that disproportionately excludes” minority candidates).

case of *Griggs v. Duke Power Company*.<sup>49</sup> In that case, Duke Power Company decided to require the passing of a standardized test and/or a high school education for certain jobs where no such educational or testing requirement was previously required.<sup>50</sup> Some of these requirements were added the day that discrimination became illegal under Title VII.<sup>51</sup> These new educational and testing requirements had the effect of disqualifying black employees from jobs at a higher rate than white employees, and the jobs in question had previously been held only by white employees.<sup>52</sup> Even though these new educational and testing requirements appeared on their face to be racially neutral, the Supreme Court held that they could nevertheless serve as the basis of a discrimination claim because they did not bear a demonstrable relationship to the performance of the jobs at issue and had a discriminatory impact on the black candidates.<sup>53</sup> The court expressly held that facially neutral employment screening procedures like testing and educational requirements may be utilized in the employment process, but such procedures must be “demonstrably a reasonable measure of job performance,” or else the procedures could be the basis of a discrimination claim if they disproportionately impact a protected class.<sup>54</sup>

While these anti-discrimination laws have been in existence for some time, the growth of social media and its use in employment complicates their enforcement. Due to the large amount of information now easily available online, potential employers have access to more information regarding an applicant’s personal life than ever before.<sup>55</sup> For example, whereas determining an applicant’s religion might have previously been fairly difficult, now an employer is able to scour the internet for publicly available social media information that might make this determination quite easy.<sup>56</sup> If an employer utilized social media to screen out all applicants that appear to be Muslim, such an act would clearly be disparate treatment and illegal under anti-discrimination laws. Such uses of social media are quite simple to handle under the law. However, some potentially discriminatory uses of social media are not quite so obvious.

Under a disparate impact theory, some seemingly benign uses of social media and online information in the hiring process can result in charges of discrimination. In one case, an employee of the National Park Service alleged that she was being discriminated against based

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<sup>49</sup> 401 U.S. 424 (1970).

<sup>50</sup> *Id.* at 427-28 (“To qualify for placement in any but the Labor Department, it become (sic) necessary to register satisfactory scores on two professionally prepared aptitude tests, as well as to have a high school education. Completion of a high school alone continued to render employees eligible for transfer to the four desirable departments from which Negroes had been excluded if the incumbent had been employed prior to the time of the new requirement.”).

<sup>51</sup> *Id.* at 427 (“The Company added a further requirement for new employees on July 2, 1965, the date on which Title VII became effective.”).

<sup>52</sup> *Id.* at 426 (noting of the new education and testing requirements “(a) neither standard is shown to be significantly related to job performance, (b) both requirements operate to disqualify Negroes at a substantially higher rate than white applicants, and (c) the jobs in question formerly had been filled only by white employees as part of a longstanding practice of giving preference to whites.”).

<sup>53</sup> *Id.* at 431.

<sup>54</sup> *Id.* at 436.

<sup>55</sup> See Mark Bannister, et. al., *Striking Gold, Not Dynamite when Using Social Media in Employment Screening*, 32 HOFSTRA LAB. & EMP. L.J. 1, 1 (2014) (“Nearly one-half of the United States population is a member of a social media site. Such sites are rich with personal information.”) (internal footnotes omitted).

<sup>56</sup> See Jennifer Delarosa, Note, *From Due Diligence to Discrimination: Employer Use of Social Media Vetting in the Hiring Process and Potential Liabilities*, 35 LOY. L.A. ENT. L. REV. 249, 263-63 (2015) (discussing how the large amount of information on social media websites can make it easy to uncover information related to a protected class and use it for discriminatory purposes).

upon her age.<sup>57</sup> One of her claims was that the National Park Service's use of Facebook to recruit new employees had a disparate impact on older applicants who may not use social media as frequently.<sup>58</sup> The Equal Employment Opportunity Commission ("EEOC") ultimately dismissed her claim, but notably it dismissed it on factual grounds, not because it was a legally invalid theory.<sup>59</sup> The EEOC noted that the employee did not produce any evidence that Facebook was the only means of recruitment nor did she produce any statistical evidence that the policy of using social media was excluding older applicants.<sup>60</sup> Thus, even though this claim was not successful, the implication is that if an employee could produce evidence that an employer was solely using social media to recruit new employees and such a policy lead to older applicants being excluded disproportionately, a disparate impact discrimination claim could potentially be successful.

Indeed, utilization of technology in general has become a hot topic for age discrimination cases. A recent article noted that many media, advertising, and technology companies are listing "digital native" as a desired attribute in employment advertisements.<sup>61</sup> While the use of such a term may seem innocuous enough, depending upon how the term is defined it carries the connotation of someone born in the digital age, and thus someone younger.<sup>62</sup> As such, some employment attorneys have argued that this is merely a veiled form of age discrimination.<sup>63</sup> This example illustrates how in the modern work, claims of discrimination can arise simply from fairly innocuous terminology used in a job listing.

This article provides only an overview of discrimination law, and there are certainly many additional technical aspects to this area. However, the focus on this article is not the various technicalities of employment law, but rather how to illustrate to students the basic practical application of anti-discrimination law in the digital world. As the above cases illustrate, the treasure trove of information available about applicants online, largely due to social media use, makes complying with the law much more difficult than it might seem at first.<sup>64</sup> Additionally, as the previously discussed study by Curran, et. al. found, there is a fundamental disconnect between what students believe they are putting online and what employers feel they can learn about potential candidates online.<sup>65</sup> Accordingly, it is incumbent on business educators to fully and effectively explain to students the practical aspects of navigating this area.

First, it is important for students to understand that information they post online can lawfully be used to make employment decisions if the information used is not related to an individual's status as a member of a protected class. For example, under federal law an employer could lawfully make employment decisions based upon an applicant's posting of information

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<sup>57</sup> See *Reese v. Salazar*, EEOC DOC 0120122339, 1 (2012), 2012 WL 5901116.

<sup>58</sup> *Id.* at 3.

<sup>59</sup> *Id.* at 4.

<sup>60</sup> *Id.*

<sup>61</sup> See Vivian Giang, *This is the Latest Way Employers Mask Age Bias, Lawyers Say*, FORTUNE (May 4, 2015), <http://fortune.com/2015/05/04/digital-native-employers-bias/>.

<sup>62</sup> *Id.* (noting that Marc Prensky, credited with coining the term "digital native," defined it as someone born during after the digital word began, which would necessarily mean the term applies to younger employees).

<sup>63</sup> *Id.* (quoting Ingrid Freeden, an attorney, as saying "The term 'digital natives' makes me cringe . . . This is a very risky area because we're using the term that has connotations associated with it that are very age-based. It's kind of a loaded term.")

<sup>64</sup> See Bannister, et. al., *supra* note 55, at 22 (discussing the difficulty that the massive amounts of information available online can create with respect to employment discrimination law, even when an employer is not intending to discriminate).

<sup>65</sup> See Curran, et. al., *supra* note 22, at 450.

related to engaging in illegal or unprofessional behavior, such as drug use, as long as that behavior is not related to membership in a protected class.<sup>66</sup> Thus, students need to be aware that information that they post online that is publicly available is not legally off-limits from consideration in the hiring process.

However, it also important to explain to students that determining what social media practices might lead to potential discrimination based upon membership in a protected class can be very difficult, particularly under a disparate impact theory.<sup>67</sup> This is critical knowledge for students not only as employment applicants, but as potential future managers making hiring decisions. For example, Kluemper, Rosen, and Mossholder conducted a study to determine whether the “Big Five” personality traits (conscientiousness, emotional stability, agreeableness, extraversion, and openness to experience) could be reliably assessed from users’ Facebook information.<sup>68</sup> Based upon an analysis of 274 undergraduate participants, the researchers concluded that their research results “suggest that evaluators trained to assess participant profiles can provide reasonably reliable estimates of Big Five personality traits from SNWs (social networks).”<sup>69</sup> The methodology utilized and the validity of these results are unimportant for the purposes of this article. Simply suppose that a company believes in the validity of this study and begins to use applicants’ available social media information to conduct personality evaluations for hiring decisions. This on its face would be a legal, non-discriminatory practice. However, just like the educational requirements in *Griggs*, if such a process results in a discriminatory impact on a protected class, unless the personality profile can be shown to be demonstrably related to job performance, it could be a violation of anti-discrimination law.<sup>70</sup> Such a result may not be intuitive to students or even many human resource professionals, but can lead to a well-meaning employment practice resulting in discriminatory outcomes and/or legal action.

In addition to the legal considerations in this area, there are important ethical and managerial considerations. It is important for those making hiring decisions to consider whether it is fair to applicants to utilize their social media information to try to make strong judgments about them. Part of the argument for the previously mentioned “lifestyle” discrimination statutes is that some believe employees should have basic privacy rights to be able to engage in lawful activities outside of work free from their employer’s judgment.<sup>71</sup> Employees may feel that their personal autonomy is being unethically invaded if an employer makes employment decisions about them based upon their personal conduct outside of work.<sup>72</sup> However, it is understandable that employers would want to utilize some of this information in employment decisions.

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<sup>66</sup> See Odo, *supra* note 12, at 7 (noting that employers could make employment decisions regarding things like “current drug abuse, negative comments about past employers, or discriminatory comments related to race, sex, or religion” without running afoul of anti-discrimination laws).

<sup>67</sup> See Bannister, et. al., *supra* note 55, at 22 (“An organization’s social media-informed employment decisions may disparately impact a protected class candidate. For example, an employer disapproving of or disliking ‘rap music’ may tend to assign low rating to or pass over applicants with ‘Likes’ and links to ‘gangsta rap’ artists. These candidates may disproportionately represent African American men.”).

<sup>68</sup> See Donald H. Kluemper, et. al., *Social Networking Websites, Personality Ratings, and the Organizational Context: More Than Meets the Eye?*, 42 J. APPLIED SOC. PSYCHOL. 1143, 1145 (2012).

<sup>69</sup> *Id.* at 1162.

<sup>70</sup> See *Griggs v. Duke Power Co.*, 401 U.S. 424, 436 (1971).

<sup>71</sup> See Sugarman, *supra* note 40, at 402-408 (discussing the employee privacy interests asserted by advocates for lifestyle discrimination laws).

<sup>72</sup> *Id.* at 406 (discussing assertions of employee personal autonomy privacy rights and noting “The underlying claim is that the employer is not treating me as a person and is showing no respect or concern for me as an individual. Instead, the employer is treating me like a statistic, as part of a group to which I have been involuntarily assigned.”).

Activities that employees engage in on their own time can have a negative impact on the employer's business through a diminished reputation or through decreased employee performance while at work.<sup>73</sup> The ethical issues here are complex, as they commonly are when conflicting rights are at stake.

An additional ethical issue is whether information obtained about a candidate online can ever be viewed without bias. A relatively recent trend in the study of business ethics is the psychological phenomenon of "bounded ethicality" – that our capacity to act upon our own stated moral values is compromised by our own psychology.<sup>74</sup> Some research in this area involves the concept of "implicit discrimination" – that people can discriminate unconsciously or sub-consciously based upon unconscious mental associations they may have regarding gender or race.<sup>75</sup> For example, one study found that resumes with "white sounding" names received a fifty percent higher call back rate than resumes with "African-American sounding" names, controlling for credentials and quality of the resumes.<sup>76</sup> While some of this discrepancy may be due to intentional racism, further studies in this area have revealed that at least some of this discrimination can be attributed to implicit, unconscious associations.<sup>77</sup>

This implicit bias clearly can, and does, occur outside the use of social media. However, due to the increased amount of information social media makes available to companies that may trigger implicit biases, these studies raise profound ethical implications with respect to utilizing social media information in evaluating candidates. This research tells us that evaluating online information objectively may be difficult, if not impossible. While implicit discrimination can occur at any level, it is arguably exacerbated when the hiring individual is viewing information online, perhaps without the proper context. A reviewer could unconsciously be looking at fairly innocuous information so as to validate existing stereotypes based upon race, gender, religion, or national origin. Even the most well-intentioned reviewer may find themselves making incorrect implicit assumptions about a candidate that would not be borne out upon actually meeting them. At best, human resource professionals should use caution regarding the veracity of the conclusions they may draw about a candidate from online information. However, as some of the previous studies discussed show, some feel that they can make strong determinations about an individual's qualification based upon the information they place online.<sup>78</sup>

With these legal and ethical issues as a backdrop, it is argued that educating students about the legal use of social media in the hiring process, both as a candidate as well as a hiring manager, requires more than just imparting information about the law, management, and ethics. Rather, to challenge students' own biases and assumptions, it is important to engage the students in exercises that simulate reviewing online information in the hiring process. In the next section,

<sup>73</sup> *Id.* at 383 (discussing employers' interest in employees' off duty behavior).

<sup>74</sup> See Tae Wan Kim, et. al., *Bounded Ethicality and The Principle That "Ought" Implies "Can"*, 25 BUS. ETHICS Q. 341, 341-42 (describing bounded ethicality).

<sup>75</sup> See Marianne Bertrand, et. al., *Implicit Discrimination*, 95 AMER. ECON. REV. 94, 94 (2005) ("Motivated by a growing body of psychological evidence . . . Sometimes, we argue, discrimination may be *unintentional* and outside the discriminator's awareness.").

<sup>76</sup> See Marianne Bertrand & Sendhil Mullainathan, *Are Emily and Greg More Employable Than Lakisha and Jamal? A Field Experiment on Labor Market Discrimination*, 94 AMER. ECON. REV. 991, 992 (2004) ("We find large racial differences in callback rates. Applicants with White names need to send about 10 resumes to get one callback whereas applicants with African-American names need to send about 15 resumes.").

<sup>77</sup> See Kim, et. al., *supra* note 75, at 342-43 (discussing further research into implicit bias).

<sup>78</sup> See Curran, et. al., *supra* note 22, at 451 (discussing HR professionals' belief that they can draw strong conclusions about candidates from social media); see also Kluemper, et. al., *supra* note 68, at 1162 (suggesting that evaluators can reach reliable conclusions about personality from Facebook information).

a classroom exercise that can help illustrate to students how they may need to modify their own social media use as a job candidate is proposed. The exercise also involves considering the ethical and legal dimensions of reviewing social media information from the perspective of a hiring professional.

#### **IV. SOCIAL MEDIA CLASS EXERCISE AND PRACTICAL GUIDANCE TO STUDENTS ON SOCIAL MEDIA USE**

To bridge the gap between knowledge of employment discrimination law and social media and its practical implementation, this article proposes an interactive classroom exercise to illustrate some of the difficulties in utilizing social media in the hiring process. First, the instructor should create example social media pages for hypothetical, fictional job candidates. Each of these fictional candidates' social media pages should reveal information (both openly and subtly) that reveals the candidate's gender, race, ethnicity, religious background, etc. A key to this exercise being successful is including information on these sample pages that students might have on their own page but may not realize could create a negative impression of them as a candidate or could potentially be used in a discriminatory manner. Examples of this type of information could include:

1. References to lyrics from popular music that could be perceived as offensive or misogynistic (for example, using vulgar language);
2. Subtle or overt references to religion;
3. Subtle or overt references to controversial political or societal issues (abortion, racial issues, sexual orientation discrimination issues, marijuana legalization, etc.);
4. Pictures or references to alcohol use, drug use, or partying in general;
5. Pictures of the candidate in provocative dress or that otherwise may be considered to be of a sexual nature;
6. Dates for when the candidate graduated from schools, or other references that might indicate age; or
7. Names that could commonly indicate nationality or race.

The overarching point is for the instructor to be creative and to create realistic profiles that could mirror those of the students, as well as the type of profiles that the students might see as hiring professionals. The profiles need to have a good mix of information that would obviously lead to a discriminatory hiring decision if considered (e.g., a clear statement of the candidate's religion) as well as more subtle information that may reveal information about a protected class, but does not do so explicitly (for example, religious references such as "being blessed" or enjoying certain music). Armed with these hypothetical profiles, the instructor and the students can then engage in various roleplaying exercises that can help illustrate some of the issues both employers and job candidates face with respect to social media.

A useful exercise that the students could engage in would be to look at a group of candidates for a position, and then have the instructor simply ask the students "Based upon just the information in these profiles, which candidates would you hire or call in for an interview?" The students could be asked to give their choices either out loud in class, or could be asked to do so in anonymous writing on notecards if that would facilitate more honest answers. Once the

responses are tabulated to determine the top candidate(s), the class could then discuss the results. The instructor should encourage open discussion of the candidates' attributes that members of the class considered to be appealing and those viewed as unappealing for the candidates who were not chosen.

Engaging in this exercise in a class of any substantial size is likely to elicit interesting discussion about selecting candidates in the digital age. It is likely that some information the students consider could be discriminatory. Additionally, some students may have to confront some implicit or explicit biases they may have. Additionally, there is likely to be a strong divergence of opinion regarding whether an employer should consider private lifestyle information, even if it is not discriminatory under federal law. Discussing the importance of privacy rights with respect to employment in the digital age is a critical discussion for students to have.

Another question which could be asked is "Imagine you are a human resource employee evaluating these profiles. What information in these profiles would you consider to convey unprofessionalism?" Again, the responses could be either oral or written, but discussing the responses is very important. If at all possible, a practicing human resources professional could be engaged to also give their opinion about the profiles. Engaging in this exercise with students can help reveal to them the difference of opinion shown in the Curran, et. al. study – students' perception of what online information is unprofessional or unappealing to employers can vary greatly from the opinions of the employers.<sup>79</sup> For example, many students' opinion about pictures and posts showing partying and alcohol use is likely to be significantly different than that of many human resource professionals. Many students may genuinely not understand how negatively employers view such information. Simply telling students that they need to be careful about what they post online will likely not have nearly the impact of actually reviewing profiles and discussing what is appropriate or inappropriate online material for a professional.

This question about professionalism also gives the class the opportunity to discuss the ethics of personal privacy and employers' use of social media.<sup>80</sup> Students and the instructor can have a robust discussion regarding the ethics of employers using information on the sample profiles that is not necessarily discriminatory but that the employer may still find undesirable. It is important that students understand the potential negative impacts on employment opportunities, whether lawful or unlawful, that posting controversial information or opinions online can have. However, it is equally important that we treat students as future potential employers, and make sure they are thinking now about whether using such information, even when it is legal, is good management or is ethical. The dividing line between our public and private lives is becoming more and more unclear as we live more of our lives in the digital world. Students benefit from grappling with the ethical and managerial ramifications of this reality early and often.

Numerous other student questions and exercises utilizing these hypothetical social media profiles can surely be imagined by the creative instructor. The overall pedagogical point is that students need to interact with the issue of discrimination and online information at the practical implementation level, not simply through learning the law in a vacuum. The more students are exposed in the classroom to the practical realities of this topic, the greater the likelihood they will make better choices in their professional and pre-professional lives.

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<sup>79</sup> See Curran, et. al. *supra* note 22, at 450.

<sup>80</sup> See Sugarman, *supra* note 40, at 402-413 (discussing employee privacy objections to employer monitoring of off-duty behaviors).

A useful aspect of the recommended teaching approach is that it can be utilized before, during, or after the students are exposed to the substantive law of this area. For example, students could be guided through these exercises and then after the experience be debriefed on the law in order to better understand whether the employment choices they made were potentially a violation of anti-discrimination law. Alternatively, these exercises can be used as illustrations while the substantive law is being taught. Finally, the exercises can be used after the students have been taught the substantive law to help them better understand and apply the law.

After completing these exercises to illustrate to students some of the practical realities of social media use, practical tips for how they can improve their own use should be provided. While it may be enticing to simply recommend that students refrain from having a social media presence, an absence of an online presence can actually be a disadvantage for an applicant.<sup>81</sup> The reality of the modern world is that more and more of our lives are lived digitally.<sup>82</sup> Students must be prepared to exist in this new environment of diminished privacy, where personal information placed online can jeopardize your career prospects for years to come.<sup>83</sup>

One of these practical tips is understanding that recruiters frequently use social media not to evaluate an applicant's hard skills or abilities to do the job, but to determine if a candidate will fit into the company's culture.<sup>84</sup> Thus, social media is a great way for potential candidates to build their own personal brand that conveys their unique personality, expertise, and style to a potential employer.<sup>85</sup> Students need to be advised that everything they put online is potentially visible to others and helps build this brand. While privacy settings are important for shielding personal information, recruiters now commonly expect candidates to have a social media presence. Thus, privacy settings should be used strategically to allow public access to selected content that is consistent with this professional brand. Additionally, each site should be reviewed to ensure a consistent professional image is portrayed and that information online is consistent with information provided in print form, such as on resumes.

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<sup>81</sup> See Dan Schawbel, *How Recruiters Use Social Networks to Make Hiring Decisions Now*, TIME (July 9, 2012), <http://business.time.com/2012/07/09/how-recruiters-use-social-networks-to-make-hiring-decisions-now/> (“First off, it’s important that you have profiles on LinkedIn, Facebook and Twitter. If you don’t, you won’t seem as relevant and companies might think that you’re hiding something.”); see also Jacquelyn Smith, *How Social Media Can Help (or Hurt) You in Your Job Search*, FORBES (Apr. 16, 2013), <http://www.forbes.com/sites/jacquelynsmith/2013/04/16/how-social-media-can-help-or-hurt-your-job-search/#efb1dc924fdb> (quoting Greg Simpson, a senior vice president, “Job seekers who are silent or invisible online may be at a disadvantage. They need to engage on social networking sites to increase their visibility and searchability with prospective employers.”).

<sup>82</sup> See Susie Poppick, *10 Social Media Blunders That Cost a Millennial a Job – or Worse*, MONEY (Sept. 5, 2014), <http://time.com/money/3019899/10-facebook-twitter-mistakes-lost-job-millennials-viral/> (quoting hiring manager Alison Green “Social media is now so woven into the fabric of young people’s lives that they forget not everything is suitable to put out there.”).

<sup>83</sup> *Id.* (“As managers grow savvy (and Facebook privacy settings grow meaningless) it is increasingly foolish to assume that those years-old photos of you double-fisting shots won’t come back to haunt you – and maybe even wreak havoc on your career.”).

<sup>84</sup> See Schawbel, *supra* note 81 (noting that “companies are inspecting social profiles to weed out candidates and get a sense of whether a particular applicant is likely to fit into the culture or not.”).

<sup>85</sup> See *Finding a Job Using Social Media: Intro*, COLUMBIA UNIVERSITY CENTER FOR CAREER EDUCATION, <https://www.careereducation.columbia.edu/resources/tipsheets/finding-job-using-social-media-intro> (last visited Feb. 9, 2016).

Additionally, since recruiters use social media to screen for negative characteristics, students need to understand the typical “red flags.” A recent survey of hiring managers in the U.S. found that items that were most likely to hurt a job candidate included:

- Provocative/inappropriate pictures
- Evidence of drinking or drug use
- Negative communication about a previous employer
- Poor communication skills
- Discriminatory language.<sup>86</sup>

## CONCLUSION

Whatever the pedagogical method employed, it is incumbent upon business school instructors to convey to students how to use social media effectively. This includes training in social media use both as student job candidates as well as future managers. A professional online presence is the new normal in the modern business world, and thus students must be prepared to cope with this reality. Understanding what a professional online presence looks like, as well as the legal and ethical ramifications of using social media in the hiring process, is a critical part of professional development. The exercise proposed in this article provides an experiential, tangible method for conveying this information to students.

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<sup>86</sup> *More Employers Finding Reasons not to Hire Candidates on Social Media, Finds CareerBuilder Survey*, CAREERBUILDER, <http://www.careerbuilder.com/share/aboutus/pressreleasesdetail.asp> (last visited Feb. 9, 2016).



## STATISTICAL EXTRAPOLATION IN COMPLEX LITIGATION: SCIENCE OR GUESSWORK?

LAURA SULLIVAN, WILLIAM HOGG AND DIANA BROWN<sup>1</sup>

### **Introduction**

When used appropriately, statistical sampling can be a powerful weapon in a litigator's arsenal. In a complex case, statistical sampling may be used to draw scientifically-supported conclusions from data, and to quantify concepts that would otherwise be amorphous, with the added bonus that it may be utilized relatively inexpensively.<sup>2</sup> On the other hand, statistical sampling has its limitations: the science can be difficult to explain, the results can only be presented as ranges which may seem imprecise to fact-finders, and the scientific methodology can be difficult to apply correctly.<sup>3</sup>

When it comes to using statistical extrapolation to calculate damages, there is no clear-cut rule of common law allowing or disallowing its use across the federal courts of the United States. Some courts cite the Seventh Amendment as authority to disallow the use of statistics in calculating actual damages, since a statistical approach may deprive the defendant of their constitutional right to have every contended fact tried by a jury.<sup>4</sup> Other courts opine that using statistics does not run afoul of the Seventh Amendment, so long as the defendant has the opportunity to challenge or rebut the statistical evidence.<sup>5</sup> The use of statistical extrapolation is already prevalent in several areas of litigation, and this paper will explore and analyze that use, and propose other areas of jurisprudence where the use of statistical sampling might be advisable. This paper will evaluate the differing treatment of statistical extrapolation between jurisdictions, the reasoning behind those opinions, and the public policies for and against using statistical extrapolation in this fashion. Finally, the paper recommends a course of action for the courts (or Congress) with regard to the use of statistical extrapolation to calculate damages.

### **Background on Statistical Extrapolation**

Statistical extrapolation is "[t]he process of estimating an unknown value or quantity on the basis of the known range of variables" or "[t]he process of speculating about possible results, based on known facts."<sup>6</sup> This process can be applied to any type of data, including calculation of damages in civil litigation. Courts have allowed sampling to calculate damages in a variety of

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<sup>2</sup>Peter Simon, Pros and Cons of Statistical Sampling, Law360, March 22, 2011, <http://www.law360.com/articles/232125/pros-and-cons-of-statistical-sampling>.

<sup>3</sup>*Id.*

<sup>4</sup>"In Suits at common law . . . the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law." U.S. Const. VII.

<sup>5</sup>See, e.g., *HCA Health Services of Kansas, Inc. v. State of Kansas*, 21 Kan.App. 2d 141 (1994).

<sup>6</sup>"Extrapolation," *Black's Law Dictionary* (9th ed. 2009), available at Westlaw BLACKS.

circumstances, including political district apportionment cases, pornography prosecutions, drug prosecutions, labor and employment litigation and others.<sup>7</sup> In cases that can include hundreds, or thousands, of potential claims within a single lawsuit, a claim-by-claim presentation at trial may simply be untenable and overly tedious, if not logistically impossible.<sup>8</sup> Alternatively, class actions that are comprised of a large number of class members and where compensatory damages need to be determined on an individual basis could be good candidates to allow sampling to determine the damages in a more efficient manner. In such instances, where the number of claims within a given case is simply overwhelming administratively and logistically, statistical sampling provides an alternative to claim-by-claim proof by providing a means of estimating with reasonable certainty the aggregation of large quantities of data without having to measure each individual data point. Accordingly, many courts accept and encourage the use of statistical sampling in certain types of cases.

Federal courts have repeatedly held that the government may use statistical sampling methods when calculating claims overpayments or actual damages in health care fraud and abuse cases. In holding that the U.S. Department of Health and Human Services enjoyed this authority, the Ninth Circuit Court of Appeals found extrapolation based on statistical sampling to be reasonable where the defendant provider had the opportunity to challenge the statistical sampling methodology.<sup>9</sup> The other federal circuit courts have held similarly.<sup>10</sup> These cases hold that a statistical sampling-based estimate of overpayment creates a rebuttable presumption that defendant providers can challenge through introduction of countervailing or claim-by-claim evidence if the provider chooses. While this practice has been widely accepted for federal health care fraud cases, such a practice could also be used in other areas of complex litigation where calculating damages on an individual-count basis would be overly burdensome for plaintiffs and the court.

This practice has spread to other areas of law over the past 40 years. In class actions, the use of extrapolation has garnered favorable rulings in several jurisdictions for class actions in general,<sup>11</sup> Title VII sex discrimination cases,<sup>12</sup> welfare rights cases,<sup>13</sup> challenges to social services

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<sup>7</sup>See Gregory Todd Jones & Reidar Hagtvedt, *Sample Data As Evidence: Meeting the Requirements of Daubert and the Recently Amended Federal Rules of Evidence*, 18 Ga. St. U. L. Rev. 721 (2002) (collected citations).

<sup>8</sup>See *Illinois Physicians Union v. Miller*, 675 F.2d 151, 158 (7th Cir. 1982) ("[I]n view of the enormous logistical problem of Medicaid enforcement, statistical sampling is the only feasible method available."); *Mile High Therapy Centers, Inc. v. Bowen*, 735 F. Supp. 984 (D. Colo. 1988) (case-by-case review not administratively feasible).

<sup>9</sup>*Chaves County Home Health Service, Inc. v. Sullivan*, 931 F.2d 914 (D.C. App. 1991).

<sup>10</sup>See *Ratanasen v. State of California Department of Health Services*, 11 F.3d 1467, 1471 (9th Cir. 1993) ("We now join the other circuits in approving the use of sampling and extrapolation as part of audits in connection with Medicare and other similar programs, provided the aggrieved party has an opportunity to rebut such evidence."); *Illinois Physicians Union*, 675 F.2d at 156; *Michigan Dept. of Educ. v. U.S. Dept. of Educ.*, 875 F.2d 1196 (6th Cir. 1989).

<sup>11</sup>*In re Simon II Litig.*, 211 F.R.D. 86, 150 (E.D.N.Y. 2002), *vacated on other grounds*, 407 F.3d 128 (2d Cir. 2005).

<sup>12</sup>*EEOC v. Joe's Stone Crab, Inc.*, 220 F.3d 1263, 1274 (11th Cir. 2000).

<sup>13</sup>*N.J. Welfare Rights Org. v. Cahill*, 349 F.Supp. 404, 409 (D.N.J. 1972), *aff'd*, 483 F.2d 723 (3d Cir. 1973).

laws,<sup>14</sup> and antitrust cases.<sup>15</sup> However, no umbrella rule has yet emerged on whether statistical sampling can be used in class actions to prove damages.<sup>16</sup> What is left is a piecemeal approach among the several different Circuit Courts and across different areas of practice.

### **Basic Explanation of Statistical Extrapolation**

In a very basic sense, extrapolation is the process of taking data that has been measured and using that data to predict what will happen in the future. The larger the sample size, the more reliable the predictions; the further you move away from the known values, the less reliable the prediction. For example, if gasoline prices for the past year are known, it is possible to estimate this year's gasoline prices with a degree of reliability. However, it may be less reliable to estimate gasoline prices two years from now based on the known data, since that may be too far away from the known values.

How does one extrapolate? Several different methods have evolved based on a simple model: assume that an infinitely large population of values exists and that your sample of that population was randomly selected from that infinite population. Extrapolation is the analysis of the sample and the utilization of the rules of probability to make inferences about the overall population. The problem becomes, then, that the statistical inferences can only apply to the population from which your samples were obtained-- but one often wants to make conclusions that extrapolate even beyond that large population. For example, assume an experiment in a biology lab setting has been performed three times. All of the experiments used the same cell preparation, the same buffers, and the same equipment. Statistical inferences allow the formation of conclusions about what would probably happen if the experiment were repeated many more times with that same cell preparation, those same buffers, and the same equipment. Limitations arise as one extrapolates further out from your data set, though, making the predictions less reliable. Using the previous example, it would be less reliable to predict the outcome if someone else repeated the experiment with a different source of cells or different instruments.

The same basic principles hold true when applied to extrapolating damages. This works both for sampling from a large number of separate transactions as well as sampling from different subsets of plaintiffs based on bellwether trials. It is possible to accurately predict what a defendant's overall liability in damages would be to an entire population of claims based on a proper sampling, *i.e.*, proper both in size--a large enough sample to accurately represent the population-- as well as selection. Both the sample size and the method of selection affect the overall level of confidence in the outcome of the prediction.<sup>17</sup> A proper sample size will depend on the number of the overall population and the desired level of confidence in the prediction, but the basic rule in statistics is that the larger the sample size, the more likely that sample will be representative of the group as a whole.<sup>18</sup>

Proper methods of selection are equally important to ensure representation of the population as a whole. One method of selection is random sampling from the population. Simple

<sup>14</sup>*In re Coordinated Pretrial Proceedings in Antibiotics Antitrust Actions*, 333 F.Supp 1173 (E.D.N.Y. 1970), *aff'd*, 402 U.S. 991 (1971).

<sup>15</sup>*In re Visa Check/Mastermoney Antitrust Litig.*, 192 F.R.D. 68, 79 (E.D.N.Y. 2000), *aff'd*, 280 F.3d 124 (2d Cir. 2001).

<sup>16</sup> Marcy Hogan Greer, Peter A. Antonucci, et al., "Chapter 18: Statistical Sampling as a Basis for Extrapolating Liability and/or Damages," *A Practitioner's Guide to Class Actions*, published by the American Bar Association, Tort Trial and Insurance Practice Section (2010).

<sup>17</sup>Keeping, E.S. (1962) *Introduction to Statistical Inference*. D. Van Nostrand, Princeton, NJ.

<sup>18</sup>David S. Moore and George P. McCabe (February 2005). "Introduction to the practice of statistics" (5th edition). W.H. Freeman & Company.

random sampling gives every subset and variable an equal probability of being selected and minimizes bias, simplifying the analysis of results. Simple random sampling can be vulnerable to sampling error, however, because the randomness of the selection may result in a sample that does not accurately reflect the makeup of the population of data.

Another method is systematic sampling, in which the target population is arranged according to some ordering technique (numerical, alphabetical, etc.) and then elements are selected at regular intervals through that ordered list, beginning at a random starting point within the list.<sup>19</sup> For example, selecting every tenth name from a telephone directory is a form of systemic sampling.

Another commonly used form of sampling is stratified sampling. Stratified sampling is used where the population embraces a number of distinct categories or sub-populations that can be organized into separate strata.<sup>20</sup> Each stratum is then sampled as an independent sub-population, out of which individual elements can be randomly selected. Each of these methods has both strengths and vulnerabilities to sampling errors, and the method should be selected based on the desired variables to be analyzed from the overall population.

### **Common Legal Challenges to Statistical Sampling**

In jurisdictions where sampling is allowed to calculate damages, the most common challenges to introducing statistical sampling evidence at trial lie in (1) the randomness and reproducibility of the sample; (2) adequacy of sample size; (3) the variability within the sample; and (4) the type of sample taken.

The validity of a statistical sample and extrapolation demands reproducibility. Where a plaintiff's statistical methods cannot be duplicated or reproduced, a defendant can make a credible argument that such a method was non-scientific (and thus, inadmissible).

The expert's full and complete documentation of his or her analysis is crucial. The expert selecting a universe of data to be sampled must record the time period to which the data pertains, to whom it pertains, and the source of the data. Decisions about changes to the universe of data should also be documented contemporaneously. Some examples of extraneous changes that should be documented include the selection of the time frame for review, the limitation of null claims, and the elimination of data based on non-numerical or nominal considerations (names, places, other non-quantifiable characteristics). Full documentation of the process ensures that another expert statistician could reproduce the analysis.

The method of randomization of the sample must also be reproducible by others. The expert witness must understand how the selection was randomized, which is usually achieved by specific algorithms.<sup>21</sup> Certain software programs used regularly by statisticians can generate random samples using specific algorithms.<sup>22</sup> These programs typically generate an identifying "seed number" to identify the random pattern selected by the software.<sup>23</sup> Since reproducibility is key to demonstrating that the process is scientific, a record of the seed number and a full

<sup>19</sup> Robert M. Groves, Floyd J. Fowler, Jr., Mick P. Couper, James M. Lepkowski, Eleanor Singer, & Roger Tourangeau, *Survey Methodology*, 2nd ed. (2009).

<sup>20</sup> Shahrokh Esfahani, Mohammad; Dougherty, Edward R. (2014). "Effect of separate sampling on classification accuracy". *Bioinformatics* 30 (2): 242–250.

<sup>21</sup> *Id.*

<sup>22</sup> Wendy Rotz, Eric Falk, Daniel Wood, Jeri Mulrow, A Comparison of Random Number Generators Used in Business, August 5, 2001,

<http://www.amstat.org/sections/srms/proceedings/y2001/proceed/00109.pdf>

<sup>23</sup> Skwara at 10.

understanding of the process by which a random sample was selected should be viewed as mandatory predicates to admissibility.<sup>24</sup> Failure to document the "seed number" could be fatal to the chances of a plaintiff intending to introduce statistical sampling evidence.<sup>25</sup>

The adequacy of sample size is another potential stumbling-block.<sup>26</sup> For instance, if a sample size is too small to support the inferences made from the sample, the analysis will be vulnerable to attack. The adequacy of the sample size is essentially a mathematical or statistical function, however, and "[t]here is no case law that states how large a percentage of the entire universe must be sampled."<sup>27</sup> As stated before, the larger the sample, the more precise the extrapolation will be. Nevertheless, a competent statistician sitting as an expert witness can use statistical error concepts such as confidence intervals and precision levels to explain within what degree of accuracy his or her extrapolation likely meshes with reality, so that even a relatively small sample of data can be the basis of extrapolation.<sup>28</sup>

Without getting too deeply into the mathematical meaningfulness of confidence intervals, it is important to understand a few different characteristics about confidence intervals to better understand the overall reliability of statistical results in general. Briefly, the higher the confidence interval, the more likely it is that the extrapolated results from a sample will accurately resemble the outcome had the entire underlying data population been analyzed.<sup>29</sup> Generally accepted benchmarks for statistical sampling are confidence intervals, or confidence levels, of 80%, 90%, 95%, and 99%. The confidence level is a function of the sample size and variability.<sup>30</sup> For example, a confidence level of 90% indicates that there is a 90% probability that the answer one would obtain from a complete analysis of the entire universe of data would fall within the range of extrapolated results. Extrapolated results are typically expressed in a range from a lower limit to an upper limit with a point estimate falling somewhere in the middle. The difference between the point estimate and the upper and lower limits is generally referred to as the "margin of error."<sup>31</sup>

The variability within a sample, sometimes stated as the coefficient of variation, can also give rise to legal challenge. Where the material data within a sample vary wildly, the reliability and the precision of the sample suffer.<sup>32</sup> For example, a random sample drawn from the entire universe of a surgeon's health care insurance claims might include low level office visits that paid tens of dollars and complicated surgical claims that paid tens of thousands of dollars. The huge variance between the office visits and the surgical costs is a high variance, which would result in a less reliable overall result. This variability can be muted by increasing the size of the sample or by thoughtful selection of the subset of data to be sampled. For example, eliminating

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<sup>24</sup>*Id.*

<sup>25</sup>*Id.* at 10-11.

<sup>26</sup>Deming, W. Edwards (1966). *Some Theory of Sampling*.

<sup>27</sup>*Michigan Dept. of Educ.*, 875 F.2d at 1206.

<sup>28</sup>RAT-STATS "Companion Manual, downloadable at <http://oig.hhs.gov/organization/OAS/ratstat.html>, describes precision and confidence levels in this context.

<sup>29</sup>Smithson, M. (2003) *Confidence intervals*. Quantitative Applications in the Social Sciences Series, No. 140. Belmont, CA: SAGE Publications.

<sup>30</sup>Kiefer, J. (1977). "Conditional Confidence Statements and Confidence Estimators (with discussion)". *Journal of the American Statistical Association* 72: 789–827.

<sup>31</sup>Fritz Scheuren (2005). "What is a Margin of Error?", Chapter 10, in "What is a Survey?", American Statistical Association, Washington, D.C.

<sup>32</sup>Forkman, Johannes. "Estimator and tests for common coefficients of variation in normal distributions" (PDF). *Communications in Statistics - Theory and Methods*. pp. 21–26.

the high-priced surgeries might make sense if the case is focused on the provider's use of office visit codes and would create a better starting universe of data that reduces variability within the subsequent sample. Stratification, discussed above, can also have a minimizing effect on variability.

Even the selection of the sample (for instance, the utilization of a simple random sample over a stratified random sample) can be a touchstone for debate.<sup>33</sup> A simple random sample may be used where the underlying dataset is relatively homogenous, meaning the factors among data points do not vary widely. Where the dataset is more heterogeneous, however, a stratified sample may be required.

A successful challenge to the use of a simple, non-stratified, random sample was mounted by a healthcare provider in *HCA Health Services of Kansas, Inc. v. State of Kansas*.<sup>34</sup> In that case, the state alleged that a medical clinic overbilled Kansas' Medicaid program by misclassifying certain emergency and non-emergency room claims and sought an overpayment amount estimated using statistical sampling. The defendant medical clinic successfully argued that the state's failure to determine in the first place whether the disputed Medicaid claims were homogenous or heterogeneous rendered the state's non-stratified sample infirm. According to the state's own statistical sampling policies, it should have made such a determination based on factors including differing procedure codes, places of service, and servicing providers. The defendant medical clinic's expert witness testified that in fact the identities of the servicing providers differed, the provider types differed, and the place of treatment differed, all of which indicated that the state should have used a stratified sample. The court agreed, holding that the "[state's] failure to determine if the population was homogenous or heterogeneous before deciding which sampling procedure to use was unreasonable, arbitrary, and capricious."<sup>35</sup>

In *United States v. Skodnek*,<sup>36</sup> for a further example, the court implicitly took issue with the absence of stratification within the sample when wondering whether the extrapolation assumed that the defendant's "illegal activities never ebbed and flowed over a five or six year period."<sup>37</sup> Had the government used a truly random, stratified sample (based on calendar year, for example) that included all data both favorable and unfavorable to the government, it may have been able to better persuade the court of the "ebbing and flowing" of the defendant's illegal activities.

In health care fraud cases, the claims data to be sampled may tend to be relatively homogenous where one claim resembles the next. For instance, a dataset consisting of an individual provider's office visit codes will tend to be homogenous. In contrast, a provider's claims dataset that includes claims for both small dollar office visits and big ticket surgery claims might require stratification when choosing an appropriate sample. Likewise, a dataset that includes multiple providers and multiple sets of service would be even more likely to be heterogeneous and require stratification.

In this sense, statistical extrapolation is not so much a method of circumventing the jury's determination of damages on an individual level, as it is a tool the court can use, in cases with an overwhelming number of individual claims, to allow calculation of damages within an

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<sup>33</sup>See, e.g., *Ratanasen*, 11 F.3d at 1471 (rejecting defendant's argument that a stratified sample was required).

<sup>34</sup>21 Kan. App. 2d 141 (1994).

<sup>35</sup>*Id.* at 157.

<sup>36</sup>933 F.Supp 1108 (D. Mass. 1996).

<sup>37</sup>*Id.* at 27.

acceptable level of confidence more efficiently and more accurately than would be possible if a plaintiff were forced to present evidence and prove individual claims one-by-one. This is especially true in cases with so many individualized claims that attempting to audit and determine the actual damages amount would be impossible in given time restrictions necessitated by trial. But this practice also applied to class actions with a large class and where damages are determined on an individualized basis for each class member.

### **Circuit Split**

While several jurisdictions accept the use of statistics to calculate damages, it is by no means a universally accepted practice. Those courts that do allow statistical sampling generally emphasize its efficiency.<sup>38</sup> Courts rejecting statistical sampling often cite due process concerns or conclude that the evidence amounts to an impermissible shifting of the burden of proof from plaintiff to defendant.<sup>39</sup> In jurisdictions that accept the practice of using statistical extrapolation to calculate damages, this is essentially how that calculation works in trial: a statistical sampling-based estimate of damages creates a rebuttable presumption that the defendant can challenge through introduction of countervailing evidence or claim-by-claim evidence, if the defendant so chooses.<sup>40</sup> This section will explore some of the different opinions about the practice and some of the rationale behind its acceptance or rejection.

#### **9th Circuit - Ratanasen**

The seminal case for allowing the use of statistical extrapolation to calculate damages is *Ratanasen v. State of California Department of Health Services*, a 1993 decision out of the Ninth Circuit. In *Ratanasen*, a doctor was investigated for fraud under the California Medicare/Medicaid program, Medi-Cal, during which the California Department of Health Services conducted an audit to look for fraud or misrepresentations in claims for payment filed by the doctor.<sup>41</sup> The State scheduled two exit conferences with the doctor prior to the final audit report, in part to allow the doctor to "explain the preliminary findings of the medical review team."<sup>42</sup> However, the doctor canceled both conferences, requesting that "either the exit interview be continued until after the criminal proceedings had been resolved, or the attorney general's office stipulate that statements made at the conference would not be used against him," a request which the Department of Justice denied.<sup>43</sup> The doctor later pled guilty, "stipulat[ing] that the basis for his plea was that he falsified patients' medical records and submitted payment claims to Medi-Cal for services he had not actually rendered."<sup>44</sup>

The final audit was conducted by "selecting a sample of 300 Medi-Cal beneficiaries out of a total of 8,761 beneficiaries," resulting in total overbillings of \$124,268.<sup>45</sup> The audit findings

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<sup>38</sup>Peter Antonucci, "Statistical Sampling as a Basis for Extrapolating Liability and/or Damages" *A Practitioner's Guide to Class Actions* Ed. Marcy Greer. Chicago: American Bar Association 2010. 495.

<sup>39</sup>*Id.*

<sup>40</sup>*See Ratanasen*, 11 F.3d at 1471 ("We now join the other circuits in approving the use of sampling and extrapolation as part of audits in connection with Medicare and other similar programs, provided the aggrieved party has an opportunity to rebut such evidence."); *Illinois Physicians Union*, 675 F.2d at 156; *Michigan Dept. of Educ.*, 875 F.2d 1196.

<sup>41</sup>*Ratanasen*, 11 F.3d at 1468.

<sup>42</sup>*Id.*

<sup>43</sup>*Id.*

<sup>44</sup>*Id.*

<sup>45</sup>*Id.* at 1469.

became final since the doctor failed to appeal the findings or the sampling methodology used in the audit.<sup>46</sup>

Roughly five months prior to the release of the final audit, the doctor filed for Chapter 11 bankruptcy. During bankruptcy proceedings, the State had filed, and was allowed, a claim for the repayment of \$124,268 found in the final audit. The doctor objected to the allowance of this claim, "alleging that the claim was the result of a random sample, which was then used to calculate an estimated overpayment," and called for an individual examination of each file to determine the actual overpayment amount.<sup>47</sup> The bankruptcy court found that the method of statistical extrapolation used was valid, and the doctor had an opportunity to receive an exit conference but chose not to participate, therefore "a hearing was not required in order for the bankruptcy court to enter judgment."<sup>48</sup> The doctor appealed the decision to the district court, which affirmed, and then appealed again to the Ninth Circuit Court of Appeals.

The Ninth Circuit held that "the use of sampling and extrapolation as part of audits in connection with Medicare and other similar programs [was proper], provided the aggrieved party has an opportunity to rebut such evidence," and "[t]o deny public agencies the use of statistical and mathematical audit methods would be to deny them an effective means of detecting abuses in the expenditure of our increasingly scarce public resources."<sup>49</sup> The court also found the sample size and method of extrapolation were appropriate.<sup>50</sup> The doctor had raised due process challenges to the random sampling, arguing that the sample size used in the audit (3.4 percent of the population) "was so small as to represent a violation of due process."<sup>51</sup> But the Court found the sample adequate because the doctor had opportunity to challenge the statistical method and chose not to participate.<sup>52</sup>

#### **5th Circuit - Cimino v. Raymark Industries, Inc.**

At the district court level of the first trial, the court in *Cimino v. Raymark*<sup>53</sup> attempted some groundbreaking and extraordinary techniques to deal with the enormous backlog of mass tort cases for asbestos litigation.<sup>54</sup> In the shadow of this behemoth of a court backlog, Judge Parker of the Eastern District of Texas attempted several techniques to consolidate, aggregate, and get these cases moving swiftly and efficiently through the court. One of these techniques used by Judge Parker, used in Phase II of the trial, was that he employed stratified sampling to try all compensatory damage claims in an aggregated trial. Parker's technique involved dividing plaintiffs into different categories based on the disease they had contracted from their exposure to asbestos, selecting a sample of cases from each disease group, trying the sample cases, and extrapolating damages for the absent class members.<sup>55</sup> The Fifth Circuit vacated the plan for two reasons. First, the lump sum award ran afoul of *Erie Railroad Co. v. Tompkins* in that it altered

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<sup>46</sup>*Id.*

<sup>47</sup>*Id.*

<sup>48</sup>*Id.*

<sup>49</sup>*Id.* at 1471.

<sup>50</sup>*Id.* at 1471-72.

<sup>51</sup>*Id.* at 1471.

<sup>52</sup>*Id.* at 1472.

<sup>53</sup> 739 F.Supp. 328(E.D. Tex. 1990), *aff'd in part, vacated in part*, 893 F.2d 706 (5th Cir. 1990) (hereinafter *Cimino I*).

<sup>54</sup> Amy Gibson, *Cimino v. Raymark Industries: Propriety of Using Inferential Statistics and Consolidated Trials to Establish Compensatory Damages for Mass Torts*, 46 Baylor L. Rev. 463, 464-65 (Spring 1994).

<sup>55</sup>*Id.* at n. 16.

Texas substantive law.<sup>56</sup> The Fifth Circuit interpreted Texas law to require individual causation, concluding the consolidation of claims in Phase II allowed a jury to accept general causation evidence, contrary to Texas law.<sup>57</sup> This aggregation skirted the individualized proof requirement needed to show that each plaintiff's injury was proximately caused by their exposure to asbestos. Secondly, the injuries to the class plaintiffs greatly differed, even within each strata of disease category. The Fifth Circuit argued that each subclass of disease carried too many differences to allow common questions of law or fact to predominate, which was in contradiction of the certification requirements of Rule 23(b)(3).<sup>58</sup>

The Fifth Circuit's decision in *In re Fibreboard* on this issue was based in part on its recognition that Rule 23 is in place, "not merely for the plaintiff's convenience, but is instead grounded in the requirements of due process and Article III."<sup>59</sup> Judge Higginbotham, a participant in the *In re Fibreboard* opinion, authored an earlier opinion in a discrimination class action that utilized mathematical models. In that opinion, Judge Higginbotham noted his concern with prevailing usage of science and statistics in overtaking functions traditionally held by the judiciary:

This concern has grown with the realization that the esoterics of econometrics and statistics which both parties have required this court to judge have a centripetal dynamic of their own. They push from the outside roles of tools for "judicial" decisions toward the core of decision-making itself. Stated more concretely: the precision-like mesh of numbers tends to make fits of social problems when I intuitively doubt such fits. I remain wary of the siren call of the numerical display and hope that here the resistance was adequate; that the ultimate findings are the product of judgment, not calculation.<sup>60</sup>

After taking this phobia of statistical inferences into account, it becomes easier to understand the Fifth Circuit's dismissal of Judge Parker's use of extrapolation. If that fear was well-founded, in that scientific mathematical models would overtake the provincial role of the judicial function, then the Fifth Circuit shutting down that use in *Cimino I* seems more justified. However, Judge Parker, in his second attempt to solve this problem, used sampling methods more as a tool of the judicial function rather than a substitute for that role.

On his second attempt, Judge Parker used a combined class action and Rule 42 consolidation in *Cimino v. Raymark Industries, Inc.*<sup>61</sup> In *Cimino II*, Judge Parker attempted to find a statistical model which would work in a way that avoided the problems with the lump sum and aggregation effects espoused as violations of due process by the Fifth Circuit. Judge Parker conducted Phase II differently in that the jury determined which plaintiffs were sufficiently exposed to asbestos-containing products to proximately cause plaintiffs' injuries. This was done

<sup>56</sup>*In re Fibreboard Corp.*, 893 F.2d 706, 711-12 (5th Cir. 1990).

<sup>57</sup> Gibson, 46 Baylor L. Rev. at 468, citing *In re Fibreboard Corp.*, 893 F.2d at 711-12

<sup>58</sup>*In re Fibreboard Corp.* 893 F.2d at 712.

<sup>59</sup> Gibson, 46 Baylor L. Rev. at 469, citing *In re Fibreboard Corp.* 893 F.2d at 712 (stating, "we are persuaded on reflection that the procedures here called for comprise something other than a trial within our authority. It is called a trial, but it is not.").

<sup>60</sup>*Vuyanich v. Republic Nat'l Bank*, 505 F.Supp. 224, 394 (N.D. Tex. 1980), vacated, 723 F.2d 1195 (5th Cir. 1984).

<sup>61</sup> 751 F.Supp 649 (E.D. Tex. 1990) (Hereinafter, *Cimino II*).

in order to remedy the problem from *Cimino I* by submitting exposure questions that were specific in time, worksite, job description, and degree of exposure.<sup>62</sup>

Phase III of the trial was the compensatory damages phase, where the claimants remained divided into their disease subcategories. A random sample was selected among each strata of disease, and these randomly selected persons would serve as class representatives during Phase III.<sup>63</sup> Each randomly selected claimant would go on to a jury trial and receive their individualized award. The absent subcategory members would receive the average damage award from their disease category. In this sense, each class member's damage award, aside from the randomly selected disease subclass representatives, relies on extrapolation.

Interestingly enough, it is unknown whether Judge Parker's rehashing of the trial plan ultimately ameliorated the problems found in *Cimino I* since the Fifth Circuit refused to examine the specific trial plan used in *Cimino II*. The court refused to hear the case on mandamus, and did so without written opinion. However, the Fifth Circuit did address that motions panel to refusing to hear the case, noting that the order was not binding.<sup>64</sup> The Fifth Circuit ultimately reversed and remand Phase III from a modified version of that trial plan as violating the Seventh Amendment, holding that Phase III of the trial plan violated the asbestos manufacturer's Seventh Amendment right to determination of whether its products caused individual plaintiffs' asbestos-related diseases and it also violated the manufacturer's right to have jury determination of distinct and separable issues of actual damages suffered by each extrapolation plaintiff.<sup>65</sup>

#### **Other Jurisdictions that Disfavor Statistical Sampling in Certain Situations**

In *Garden City Treatment Center, Inc. v. Coordinate Health Partners, Inc., et al.*,<sup>66</sup> the Rhode Island Supreme Court found the concept of statistical sampling convoluted. In that case the plaintiff, an emergency care facility, filed suit against Blue Cross of Rhode Island as a result of various claims audits performed by Blue Cross of Rhode Island. In those audits, Blue Cross sampled a subset of the plaintiff's claims and found overpayment rates of 29% and higher, meaning 29% of the claims in one sample were found to have included excess payments. Blue Cross of Rhode Island applied those overpayment rates to the entire universe of claims from which each sample was drawn and extrapolated an overpayment amount. Acknowledging that Blue Cross of Rhode Island enjoyed the contractual right to audit its claims, the plaintiff claimed that the extrapolation nonetheless violated the parties' contract since the contract did not expressly grant Blue Cross of Rhode Island the ability or the right to use statistical sampling or extrapolation.

The trial court in *Garden City* determined that the entire case turned on the definition of "audit" in the contract. Consulting Black's Law Dictionary, the trial judge held that Blue Cross of Rhode Island could not extrapolate because the dictionary definition of "audit" did not refer to extrapolation or statistical methods. Blue Cross of Rhode Island appealed, and the Rhode Island Supreme Court confirmed the trial court's decision, holding that Blue Cross of Rhode Island's contractual right to "audit" the plaintiff allowed only for a record-by-record review.<sup>67</sup> Therefore, Blue Cross of Rhode Island could not seek to collect the overpayment amounts reached though

<sup>62</sup>*Id.* at 653.

<sup>63</sup>*Id.* at 658-59.

<sup>64</sup>*Cimino v. Raymark Industries, Inc.*, 151 F.3d 297, 311 n. 26 (5th Cir. 1998).

<sup>65</sup>*Id.* at 311-13.

<sup>66</sup>852 A.2d 535 (R.I. 2004).

<sup>67</sup>*Id.* at 543 ("a case-by-case or record-by-record examination more closely fits the ordinary understanding of audit.").

extrapolation but still enjoyed the ability to "audit," for example, all 22,518 claims submitted by the plaintiff to Blue Cross of Rhode Island in the year 2000.

Based on this narrow ruling, the *Garden City* decision will not likely garner a dutiful following. The concurring opinion, written by Justice Flanders, criticizes the majority's focus on whether the dictionary definition of "audit" refers to statistical sampling and instead argues that the plaintiff's motion for summary judgment should have hinged on whether Blue Cross of Rhode Island could establish that it used proper statistical sampling methods. Justice Flanders explained that the use of statistical sampling was a question of evidence, not a contractual issue: "absent some valid contractual provision or law preventing them from doing so, and subject to the rules of evidence governing the admission of expert testimony, I would hold that parties may freely use statistical sampling as a method of proving alleged overcharges in situations such as the one presented by the case at bar."<sup>68</sup>

Most courts generally accept the evidentiary concept of statistical sampling, but it has been rejected in specific cases due to methodological infirmities. For example, the court in *United States v. Skodnek*<sup>69</sup> rejected the government's extrapolation of fraudulent claims for purposes of calculating a "loss" figure for sentencing in a criminal case. In *Skodnek*, the government had proven at trial that defendant Skodnek had submitted \$157,460 in fraudulent claims to Medicare and private payers of claims; based on those proven fraudulent claims, the government extrapolated a "loss" attributable to Skodnek of \$1,218,454 during the sentencing phase of the proceeding.<sup>70</sup>

The *Skodnek* court observed that "[i]n order to accept the picture offered by the government with respect to the entire universe of fraudulent billings, I have to accept that Skodnek almost never honestly billed a single patient, never forgot to bill for time he had actually spent with them . . . , and that his illegal activities never ebbed and flowed over a five or six year period."<sup>71</sup> The court found that this "picture" was undermined by evidence in the case. And commenting on the government's extrapolation sample, the court disparaged it as a "convenience sample, garnered by a unit whose purpose is to investigate fraud."<sup>72</sup> "Clearly, the interviewers were searching out 'horror' stories, the stuff of which criminal prosecutions can be made or sentencing increased [and] there were instances in which [patient] reports apparently inconsistent with the overall conclusions were ignored."<sup>73</sup> The cherry-picked sample of fraudulent claims in *Skodnek* was thus rejected as a basis for extrapolation of the fraud loss for sentencing purposes, but the jury had otherwise found Skodnek guilty on many counts of health care fraud against Medicare and private payers.

Another case rejecting sampling to prove False Claims Act liability is *United States v. Medco Physicians Unlimited*.<sup>74</sup> In that case, the court denied the Government's motion for summary judgment in part because the Government sought to rely on expert analysis of sixteen patient files and to extrapolate from that analysis to all claims submitted to Medicare by the defendant. The experts determined that the sixteen patient files revealed that the defendant billed Medicare for non-medically necessary services. The Government then argued that all claims

<sup>68</sup>*Id.* at 547.

<sup>69</sup>933 F.Supp. 1108 (D. Mass. 1996).

<sup>70</sup>*Id.* at 1110.

<sup>71</sup>*Id.* at 1117.

<sup>72</sup>*Id.*

<sup>73</sup>*Id.* at 1117.

<sup>74</sup>2000 U.S. Dist. LEXIS 5843 (N.D. Ill. 2000).

submitted by the defendant in the year in question should be deemed false. the court summarily rejected the proposed extrapolation, stating that there was "no case law or other authority to support such a request."<sup>75</sup> Moreover, held the court, the Government had not even shown that the defendant billed Medicare or was reimbursed for those sixteen patients.

The recounting of a Social Security Administration case similarly highlights a court's rejecting statistical sampling in light of specific methodology problems.<sup>76</sup> In this overpayment case, a representative of the Office of Inspector General ("OIG") testified that his office did not review a 400-claim sample, the minimum necessary statistically, due to "lack of audit resources and availability of staff." The OIG also failed properly to document and preserve its sampling methodology such that it could be replicated. Therefore, the Social Security Administration's Office of Hearings and Appeals overturned a \$1,248,747 overpayment determination.<sup>77</sup>

Also unsuccessful was a plaintiff relator's attempt to employ a novel application of statistical sampling in *United States ex rel. Kusner v. Osteopathic Medical Center*.<sup>78</sup> In *Kusner*, a civil False Claims Act case, the relator relied upon *Ratanasen* and other federal cases endorsing statistical sampling when attempting to ameliorate the fact that neither he nor defendants had relevant billing records for much of the relevant time period. Though the relator had no knowledge of whether underlying individual patient billing records existed, the relator argued that an expert statistician could make a projection of damages. The relator made this argument even though the defendants submitted evidence that individual patient records did not exist and the billing records that did exist contained inconsistencies and data integrity issues.<sup>79</sup> The court held otherwise, noting that *Ratanasen* and like cases were "distinguishable, however, because they all involve, in some form or another *actual* billing records from which extrapolations were made."<sup>80</sup> In other words, the relator proposed to sample non-existent data.<sup>81</sup>

### **Public Policy Concerns**

One of the mainstay arguments for allowing statistical extrapolation to calculate damages is that proper statistical methodologies garner more accurate results than a transaction-by-transaction approach. One can imagine a scenario wherein a plaintiff is forced to analyze thousands upon thousands of transactions across a panoply of different documents within a finite timeline in order to come up with a damage amount that would comport with this transaction-by-transaction approach. Given such time constrains, inaccuracies would be expected and such a scenario would undoubtedly result in inaccuracies from the massive amounts of data needed to be pored over by not-nearly enough reviewers in too short a time. Inaccuracies would be inherent, but the problem is that the degree of inaccuracy in those kinds of situations is unknowable.

With proper use of statistical extrapolation, there are inherent inaccuracies within the projection since no statistical prediction can ever be made with 100% certainty. But those inaccuracies can be measured and the formulas can be tailored to achieve an acceptable level of

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<sup>75</sup>*Id.* at 23.

<sup>76</sup>See Holland & Hart, *Roaming the Random Range*, March 2003 Health Care Law Bulletin (describing *In re American Health Services*, HICN 103-01-007 A (2000)).

<sup>77</sup>*Id.*

<sup>78</sup> 1997 U.S. Dist. Lexis 16855 (E.D. Pa. Oct. 23, 1997).

<sup>79</sup>*Id.* at 21.

<sup>80</sup>*Id.* (emphasis in original).

<sup>81</sup>See also *United States ex rel. Aflatooni v. Kitsap Phys. Svc.*, 314 F.3d 995 (9th Cir. 2002) (cannot imply falsity of claims in FCA case from circumstantial evidence where no actual claims are in evidence).

confidence in the results. For example, a national opinion poll might show the president's approval rating to be, say, 47% with a margin of error of plus or minus two percent. The calculation of this margin of error is a result of several different factors, but mainly from the sampling size as compared to the overall population. Likewise, where a calculation of damages carries with it a margin of error, both in an individual claim count and a statistical extrapolation of the damages, it would undoubtedly be more desirable for both plaintiffs and defendants to be able to gauge that margin of error with a degree of accuracy.

This practice would be more desirable for plaintiffs in cases with massive amounts of transactions, documents, and claims. It would make it more efficient, less costly, and, at least in some cases, simply feasible to make a calculation at all. This would ease the burden on plaintiffs in calculating damages, but it would also ease the burden on defendants as well.

For instance, a bungled individual count of damages may result in a figure that is far higher than the actual amount of damages at issue. One can imagine a scenario where an audit of defendant's records, performed hastily and sloppily by plaintiff's auditors, returns a calculation of damages much higher than what a more careful audit would produce. Recognizing the figure to be off the mark, the defendant is faced with a choice: First, on the chance the plaintiff's audit returned a result that was too high, the defendant could conduct their own audit to challenge the plaintiff's assertions. This would prove costly and time-consuming for the defendant, as well as put extra stress on the court which would already be greatly constrained with time. Or second, do nothing on the chance that plaintiff's audit was either spot-on or too low, and simply absorb the risk that plaintiff's audit may have been too high. A prudent defense attorney would not likely approach a calculation of damages as carefree as choice two, and would likely conduct their calculation of damages by statistical extrapolation anyway to save both time and money in analyzing the plaintiff's calculation of damages for accuracy.

This rationale has been widely accepted in Medicare/Medicaid fraud cases and antitrust jurisprudence; cases in which the overall number of transactions is overwhelming for the government or private plaintiffs to audit in a given time period. The same rationale has been applied to areas similar to the problem found in the *Cimino* line of cases such as welfare rights and Title VII class actions, where there is a class action with a large class and determining individualized damages would create an unreasonable burden for the court system. So in what ways can this rationale be applied to other areas of law? The following list is representative of, but in no way an exhaustive list of, the areas of law to which statistical extrapolation of damages calculations could be applied.

### **Antitrust**

"As construed by the courts, basic requirements for recovery [of damages in antitrust litigation] include the 'fact' of injury to the plaintiff, proof that the defendant's antitrust misconduct was a 'material' or 'proximate' cause of the . . . injury, and a 'just and reasonable estimate' of the damage.<sup>82</sup> Once the conditions are met to prove damages, the courts usually require a "reasonable estimate of the amount of damages sustained."<sup>83</sup> Proving antitrust damages, therefore, necessarily requires at least some amount of estimation.

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<sup>82</sup>Holmes and Mangiaracina, *Antitrust Law Handbook* § 9:26, citing *J. Truett Payne Co., Inc. v. Chrysler Motors Corp.*, 451 U.S. 557, 561-63 (1981); *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 401 U.S. 321 (1971); *Bigelow v. RKO Radio Pictures*, 327 U.S. 251, 264 (1946).

<sup>83</sup>*Id.*

In estimating damages, it would be preferable to use the most accurate method of estimation possible, which may be statistical extrapolation in some cases. As the Eleventh Circuit stated in *Graphic Products Distributors, Inc. v. ITEK Corp.*:

Once an antitrust violation and its causal relation to plaintiff's injury have been established, the burden of proving the amount of damages is much less severe. . . . While a jury may not base its judgment on speculation or guesswork . . . all that can be required is a just and reasonable--albeit necessarily imprecise--estimate based upon relevant data.<sup>84</sup>

As discussed above, proper use of statistical extrapolation techniques produces the "reasonable estimate based upon relevant data" required by the *Graphic Products* decision. In antitrust cases that require an estimate of damages as outlined in *Graphic Products*, statistical extrapolation is commonly used as the best option for an accurate estimate of "necessarily imprecise" damages.<sup>85</sup>

This process of [proving damages in antitrust] involves two related comparisons. First, the plaintiff establishes the evidentiary foundation by comparing its actual experience in the damage period with the experience in a foundation or base period in which the defendant's illegal conduct did not affect the market. This foundation provides the basis for projecting the plaintiff's but-for experience. Second, the measure of damages is determined by comparing the plaintiff's but-for experience with its actual experience in the damage period.<sup>86</sup>

At its most basic level, this process is a very rudimentary application of statistical extrapolation. As previously discussed, extrapolation is merely the process of projecting known data into its rational extension of an unknown area. This is the common way courts determine antitrust damages based on economic harm. Although there are exceptions to this process, statistical extrapolation in calculating damages is nevertheless widely accepted as a valid method in antitrust jurisprudence.

Even before the question of damages ever arises, a class action in antitrust may face significant hurdles in passing the certification stage. In *In re Visa Check/Mastermoney Antitrust Litigation*,<sup>87</sup> the court analyzed a certification motion by class members in light of *Caridad v. Metro-North Commuter R.R.*<sup>88</sup> The class members in *Caridad* alleged a company-wide policy of discrimination against African-Americans who sought to certify a class of all African-American employees who held union or lower- to middle-level management positions.<sup>89</sup> "In support of their motion, the plaintiffs submitted a statistical analysis showing that African-American employees faced discipline from Metro-North with more frequency than other employees and were promoted less often."<sup>90</sup> The district court rejected the statistical analysis as a basis for establishing commonality under Rule 23(a) and the Second Circuit reversed this finding. The Second Circuit disagreed with the district court's short-shrift treatment of the statistical analysis,

<sup>84</sup>717 F.2d 1560, 1579 (11th Cir. 1983).

<sup>85</sup>Roger D. Blair & William H. Page, "Speculative" Antitrust Damages, 70 Wash. L Rev. 423, 435-37 (1995).

<sup>86</sup>*Id.* at 437.

<sup>87</sup>192 F.R.D. 68 (E.D.N.Y. 2000), *aff'd*, 280 F.3d 124 (2d Cir. 2001).

<sup>88</sup>191 F.3d 283 (2d Cir. 1999).

<sup>89</sup>*In re Visa Check*, 192 F.R.D. at 80, *citing Robinson v. Metro-North Commuter R.R. Co.*, 175 F.R.D. 46, 47 (S.D.N.Y. 1997), *rev'd sub. nom.*, *Caridad*, 191 F.3d 283.

<sup>90</sup>*Id.*

noting that the district court's "statistical dueling" is not relevant to the certification determination, though "[t]he critique may prove fatal at the merits stage, but the Class Plaintiffs need not demonstrate at this stage that they will prevail on the merits."<sup>91</sup> Thus, the Second Circuit instructed district courts that:

In deciding a certification motion, district courts must not consider or resolve the merits of the claims of the purported class. Here, the District Court credited Metro-North's expert evidence over that of the Class Plaintiffs. Such a weighing of the evidence is not appropriate at this stage in the litigation.<sup>92</sup>

The Second Circuit's handling of the use statistics in the certification phase should be instructive to other courts. Given the limited considerations of a class certification motion, and assuming the use of statistics in such a situation is not misleading or improperly conducted, courts should not have trouble applying the Second Circuit's framework for allowing the plaintiffs to use statistical analysis in establishing commonality.

### **Title VII**

Another area of law that might be amenable to statistical extrapolation of damages is Title VII class action suits. Title VII of the Civil Rights Act of 1964 authorizes employees of certain employers, and members of certain unions, to file civil actions against those employers or unions if they claim to have been the victims of discrimination based on race, color, religion, sex, or national origin.<sup>93</sup> In Title VII class actions that are subject to compensatory and punitive damages, calculating damages can become very complicated and convoluted as the class grows. While punitive damages are generally capped, compensatory damages can still be determined individually.<sup>94</sup>

For example, if a large employer like Wal-Mart were sued in a class action under Title VII (assuming the class passed the class certification requirements and won the suit), calculating compensatory damages to a potential class of thousands of members would be far too cumbersome since the court would have to try each compensatory claim individually. Much like the class calculation in *Cimino II*, where Judge Parker split the class into sub-groups based on disease category, then held bellwether trials and attributed several different damages calculations as applied to their applicable sub-groups, so in a Title VII scenario, the relevant sub-groups might be an identifiable age group breakdown among women, for instance.<sup>95</sup> Or a breakdown of different identifiable racial groups if the suit was brought under a theory of minority discrimination. In the situation of a large class of individuals within a diverse group of class members, the statistical extrapolation method utilized by Judge Parker in *Cimino II* might be a valuable and efficient expedient in calculating damages.

### **Breach of Contract Class Actions**

Similar to Title VII claims, breach of contract class actions can involve a large number of class members and individual compensatory damages. For instance, in *Iliadis v. Walmart-Stores, Inc.*, the court considered a breach of contract class-action case wherein Plaintiffs alleged that Wal-Mart, in an effort to reduce labor costs and increase profits, systematically declined to honor

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<sup>91</sup>*Id.*, citing *Caridad*, 191 F.3d at 283.

<sup>92</sup>*Caridad*, 191 F.3d at 283.

<sup>93</sup> 42 U.S.C. §§2000e *et seq.*

<sup>94</sup> Sex-Based Employment Discrimination § 14:5.

<sup>95</sup>*Infra.*

its contractual promises concerning rest and meal breaks.<sup>96</sup> The court ultimately decided that class certification was warranted and that, despite Walmart's argument that the statistical data would prevent it from challenging the individual class member's claims, common questions of law and fact prevailed.<sup>97</sup>

### **Conclusion**

While the tide in favor of statistical extrapolation seems to be turning in favor of allowing such statistics to calculate damages, it is a slow-moving process. Currently, the biggest impediments to allowing this practice are individual state laws that prohibit the practice. And where state laws vary on this issue, the federal courts' practices will also vary, at least in diversity suits. Whatever the reason, the current common law on the use of statistics to calculate damages is non-uniform and complicated. And while a glacial shift is taking place in favor of allowing statistical extrapolation, Congress or the Supreme Court should settle the issue universally.

As the cases supporting use of statistics to determine damages show, such use does not displace the judicial function and can be utilized in ways that comport with the defendants' Seventh Amendment right to have each claim tried by a jury. Even a simple alteration such as burden-shifting, in which plaintiffs are allowed to present statistical evidence of damages, then defendant would bear the burden to challenge such evidence with either their own statistical study or a transaction-by-transaction individual count, would be a much-needed change to the current landscape.

As suggested in this paper, use of statistical extrapolation should be allowed for complex litigation where proving damages by an individual count would be an overly burdensome time constraint for the plaintiff and/or the court. There are various situations that may apply, but essentially this tool should be saved for litigation where either (1) there are a few plaintiffs, or even a single plaintiff, but the overall number of transactions at issue are so overwhelming that an individual count would be an unreasonable burden, or (2) a potentially large class action where calculating damages would require an implausibly high number of individual trials for each member of the class. The first situation closely mirrors the Medicare/Medicaid fraud cases like *Ratanasen*, involving a small number of plaintiffs and a large number of transactions at issue. The second situation follows the class actions like *Cimino*, with a large class and overly-burdensome individual calculations of damages. Either way, these kinds of cases could be characterized as labyrinthine complex litigation.

Given the vastly different ways that courts across the country treat statistical extrapolation, the best chance for getting this practice accepted nation-wide, at least on the federal level, would be legislation. This kind of legislation is not likely to be introduced any time soon, given the political blandness of the topic. Statistical extrapolation of damages is admittedly not a very politically sexy topic. But if there is some kind of push by special interest groups, perhaps by plaintiffs' attorneys or class action associations, such legislation allowing some form of this practice is not out of the realm of possibility. Especially if introduced on the premise of easing the burden of courts in overseeing otherwise docket-clogging litigation. Aside from legislation on the issue, precedential court decisions show no sign of converging on any decision one way or the other.

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<sup>96</sup>922 A.2d 710 (N.J. 2007).

<sup>97</sup>*Id.* at 717-18. But see *Rollins Inc. v. Warren*, 653 S.E.2d 794 (Ga.App. 2007)(rejecting statistical evidence in breach of contract class action due to highly individualized nature of claims).

The current state of the federal practice on admission of statistical extrapolation evidence for calculating damages is fractured and inconsistent, forcing an inefficient and costly system on the courts, plaintiffs, and defendants alike. It is also conducive to forum-shopping, since if the class action litigation is filed in one the jurisdictions that allows statistical extrapolation evidence, plaintiffs will recognize cost savings over and above a transaction-by-transaction account. But as long as luck, or forum shopping, is the deciding factor on whether plaintiffs are allowed this tool in calculating damages in highly complex litigation, the system will remain flawed and unpredictably inaccurate.



## THE PROFESSIONAL ETHICS OF U.S. TAX TREATY INTERPRETATION

BRET N. BOGENSCHNEIDER\*

### Abstract

*The use of tax treaties to obtain Double Non-Taxation for multinational firms as part of aggressive tax avoidance planning is not always ethical conduct for U.S. tax professionals. Under the guidance of the Organization for Economic Co-operation and Development (OECD), international standards of tax treaty practice are trending toward substantive methods of interpretation more typical of U.S. tax treaty drafting and interpretation. In a growing number of cases, the use of formalist planning techniques that apply tax treaties without a substantive review may not constitute ethical attorney conduct. This paper explains in detail the interpretational methods underlying the use of tax treaties to obtain Double Non-Taxation. Because tax treaty interpretation is an art and not a science, wide discretion is available to the tax planner. Yet, there are ethical boundaries in interpreting tax treaties to achieve Double Non-Taxation.*

### Outline

- I. Introduction.
  - a. Explanation of the term: *Double Non-Taxation*.
  - b. Ethical Implications when the Tax Lawyer “Switches Hats”.
- II. Background on Tax Treaty Interpretation.
  - a. OECD Model Treaty and Interpretational Norms.
  - b. Technical Analysis of Treaty-based Double Non-Taxation.
  - c. Non-Standard U.S. Methods of Tax Treaty Interpretation.
- III. Ethical Considerations in Tax Treaty Planning by U.S. Tax Professionals.
  - a. The Ethics of U.S. Tax Treaty Planning in Light of Limitation-on-Benefit Clauses.
  - b. The Ethics of (Double-Exemption) Foreign Treaty Planning after BEPS.
- IV. Conclusion.

## I. Introduction.

The professional ethical standards for U.S. tax professionals engaged in foreign tax planning are often not well-understood by practitioners especially when it comes to the facilitation of aggressive tax avoidance by multinational firms. In particular, ethical considerations arise when in-house tax attorneys and accountants of U.S. multinationals engage in tax avoidance planning with respect to tax treaty interpretation. The practical reason for this is that the American Bar Association (ABA) Ethics Committee Opinion 85-532<sup>1</sup> identified tax return preparation as an *adversarial* legal proceeding where the opposing party to tax avoidance is taken as the foreign taxing authority.<sup>2</sup> And, this is true even where the tax return is accepted without audit or legal challenge. All tax avoidance planning is thereby effectively included as a preliminary aspect of the filing of the tax return. In the context of such an “adversarial” proceeding, the tax lawyer is not typically required to disclose aggressive tax avoidance planning to the opposing party.<sup>3</sup> The ABA’s identification of tax planning as an adversarial proceeding thus limits the potential for a tax practitioner acting on behalf of a multinational firm to run afoul of ethical requirements at least by failing to disclose aggressive tax planning or interpretations of laws. Yet tax practitioners still potentially face issues of ethical conduct in tax treaty interpretation.

Perhaps the quintessential example of aggressive tax planning via legal interpretation is the interpretation of tax treaties in ways that lead to Double Non-Taxation. The term “Double Non-Taxation” has many meanings (as explained in detail in the next section). The pertinent issue is where U.S. multinational firms use a tax treaty to achieve double exemption from taxation in the two countries party to the treaty. The term “tax treaties” includes both tax treaties concluded by the U.S. Treasury and approved by the Senate, and also foreign tax treaties that a multinational firm uses as part of its foreign tax planning designs. Assistance in aggressive tax avoidance on behalf of a multinational firm raises risks of a professional challenge from the Internal Revenue Service, although admittedly the risks are less than for aggressive tax planning on behalf of an individual.<sup>4</sup>

The U.S. tax professional is technically covered by the U.S. Treasury’s rules of professional conduct when acting on behalf of a multinational. This is because “practice” is understood as including the preparations for the filing of a tax return (including foreign tax avoidance planning), even if a return is not filed with the Internal Revenue Service.<sup>5</sup> The U.S. international tax system is designed to credit foreign taxes upon repatriation of foreign earnings back to the United States. Historically, the Internal Revenue Service was at times concerned with the *overpayment* (not the underpayment) of foreign tax by U.S. multinationals to foreign taxing authorities, because the foreign tax credit mechanism overpayment could result in a *higher* offsetting credit in the United States. Considering the historical situation where U.S. multinationals tended to repatriate foreign earnings, the avoidance of foreign tax

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<sup>1</sup> ABA COMMISSION ON ETHICS & PROFESSIONAL RESPONSIBILITY, Formal Op. 85-352 (1985).

<sup>2</sup> See Theodore C. Falk, *Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 TAX LAW 643 (1986); Loren Prescott, Jr., *Challenging the Adversarial Approach to Taxpayer Representation*, 30 LOY. L.A. L. REV 693 (1997).

<sup>3</sup> Linda Galler, *The Tax Lawyer’s Duty to the System*, 16 VA. TAX REV. 681, 697 (1997).

<sup>4</sup> Such offshore tax avoidance planning for individual clients amounts to a separate issue and is beyond the scope of this article.

<sup>5</sup> See Circular 230 § 10.2(a)(4) (“Practice before the Internal Revenue Service” comprehends all matters connected with a presentation to the IRS or any of its officers or employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.”); American Bar Association, Ethical Issues in Federal Tax Practice Standards of Tax Practice: ABA Section of Taxation <[www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-butler-ethicalissuesinfedtaxprac.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-butler-ethicalissuesinfedtaxprac.authcheckdam.pdf)>.

could theoretically result in relatively higher tax remittances to the U.S. treasury and less to the foreign taxing authority (thus, netting to the U.S. corporate rate in aggregate after the foreign tax credit).<sup>6</sup> If the foreign corporate tax rate were higher than the U.S. tax rate, then the U.S. fisc could even benefit by the non-payment of incremental tax to the foreign fisc where the foreign taxes were aggregated into a larger pool of earnings and profits,<sup>7</sup> as can be illustrated with a standard foreign tax credit planning technique.<sup>8</sup>

In the modern era, however, U.S. multinationals are increasingly designating offshore profits as permanently reinvested earnings (“PRE”) for accounting purposes, meaning the profits will never return to the United States (at least for tax purposes) and residual U.S. tax will not be collected.<sup>9</sup> Hence, any historical disincentive for the Internal Revenue Service to turn a blind-eye toward concerns regarding professional conduct relating to tax remittance to the foreign fisc is now quickly evaporating. The new trend toward exchange of information between taxing authorities could result in greater collaboration between U.S. and foreign taxing authorities. The U.S. Treasury could thereby become more aware of factual mismatches (i.e., transfer *mispricing*) between jurisdictions, which might in some cases constitute professional misconduct by the responsible tax lawyers or accountants.<sup>10</sup>

The thesis of this paper is that a U.S. tax professional advising toward treaty-based Double Non-Taxation could constitute unethical attorney conduct at least in egregious cases. Because the U.S. method of tax treaty drafting and interpretation is non-standard from an international perspective, the ethical concerns expressed herein relate particularly to U.S. tax professionals. Ethical misconduct is more likely now given that the “single tax” principle is the legal norm as a matter of the U.S. method of tax treaty interpretation.<sup>11</sup> A substantive method of treaty interpretation is not merely an implied anti-abuse rule or what Europeans might call a General Anti-Abuse Rule (“GAAR”). The prior arguments in favor of Double Non-Taxation developed in the IFA 2004 Report now are questionable in light of the OECD Base Erosion and Profit Shifting (BEPS) initiatives where the trend is toward U.S. methods of tax treating drafting and substantive interpretation.<sup>12</sup> Furthermore, the U.S. tax lawyer advising toward Double Non-Taxation on the basis of a foreign tax treaty may also be engaged in unethical attorney conduct where the desired result is indeterminate. The

<sup>6</sup> See Internal Revenue Code §901.

<sup>7</sup> Earnings and profits (referred to as “E&P”) are a tracking mechanism in the U.S. tax code for accruals of foreign profits that are intended to match with foreign taxes paid in order to determine the tax amount of the foreign tax credit and the residual U.S. tax that should be paid by the U.S. multinational upon repatriation of the particular E&P; see Internal Revenue Code §316.

<sup>8</sup> A standard technique of foreign tax credit planning with higher foreign tax rates (e.g., greater than 35%) is to allow the E&P to build for a period of time and then to combine the high-taxed E&P pool with a lower-taxed E&P pool, and only then repatriate the foreign earnings. Any foreign taxes above the illustrative 35% U.S. rate thus do not go to waste.

<sup>9</sup> Accounting Standard Codification §740 (“Permanently Reinvested Earnings”); Accounting Pronouncement Bulletin Opinion No. 23; see also Linda K. Krull, *Permanently Reinvested Foreign Earnings, Taxes, and Earnings Management*, 79:3 ACCOUNTING REVIEW 745 (2004).

<sup>10</sup> See generally Don Hansen, Rick Crosser & Doug Laufer, *Moral Ethics vs. Tax Ethics: The Case of Transfer Pricing amongst Multinational Corporations*, 11 J. BUS. ETHICS 679 (1992).

<sup>11</sup> Reuven S. Avi-Yonah, *Who Invented the Single Tax Principle?: An Essay on the History of U.S. Treaty Policy*, 59 N.Y.L. SCH. L. REV. 309, 315 (2014/15) (“The single tax principle states that income should be subject to tax only once, and thus rejects both double taxation and double non-taxation. The rejection of double taxation was, of course, the inspiration for the entire international tax regime. But where does this rejection come from?”).

<sup>12</sup> BEPS Action 6: Prevent Treaty Abuse <[www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf](http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf)>; see also Yariv Brauner, *What the BEPS?* 16 FLA. TAX REV. 55 (2014); Avi-Yonah at 315 (“The rejection of double non-taxation under tax treaties can be traced to the first U.S. model tax treaty from 1981. Before that model, while the United States took steps to restrict double non-taxation of its residents, it generally permitted double non-taxation of non-residents. After 1981, the United States increasingly limited double non-taxation of non-residents, leading to the adoption of the single tax principle by the OECD.”).

holdings in *Gregory v. Helvering*<sup>13</sup> and *Duke of Westminster*<sup>14</sup> were premised on determinate tax planning where the legal restructuring had an identifiable purpose with a determinate outcome under applicable tax laws. The holdings clearly did not apply to the creation of an artificial structure with an indeterminate legal status under applicable tax laws.<sup>15</sup> As explained here, treaty-based Double Non-Taxation is often premised on legal indeterminacy, which is by extension also not covered in the seminal *Gregory v. Helvering* decision.

**a. Explanation of the term: Double Non-Taxation.**

International tax avoidance planning by multinationals often involves the seeking out of what is often referred to as: “Double Non-Taxation”.<sup>16</sup> As all tax professionals are certainly aware, such Double Non-Taxation can arise in a variety of ways.<sup>17</sup> Reuven Avi-Yonah described what might be called the “usual suspects” in Double Non-Taxation as follows:

An entire industry of tax arbitrage has arisen, which seeks to exploit differences among various countries' tax regimes in order to create double non-taxation. In 1997, the United States adopted the “check the box” rule, which vastly enhanced the capability of sophisticated tax lawyers to use hybrid entities as well as hybrid instruments (such as debt in one country and equity in another) to achieve double non-taxation. Other forms of double non-taxation result from shifting profits via transfer pricing or deductible interest, as well as royalty payments, to tax havens.<sup>18</sup>

The regulations that became known as “check-the-box” were promulgated by the U.S. Treasury department in the year 1997.<sup>19</sup> These regulations allow enhanced flexibility for multinationals to engage in aggressive tax avoidance planning, particularly for the exploitation of hybrid entity mismatches between taxing jurisdictions (i.e., the first jurisdiction sees a legal entity as a pass-through and the other jurisdiction sees the legal entity as a corporation). The mismatch in entity characterization can then often be exploited in the particular terms of a tax treaty. In years following the promulgation of “check-the-box” regulations, there has been an explosion of Double Non-Taxation planning amongst multinationals, along with designation of foreign earnings as PRE. In essence, this means

<sup>13</sup> *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *see also* Rachele Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 34 (2010) (“It has long been argued that taxpayers are free to manage their affairs in a way that minimizes their tax liability. However, many view this exploitation by MNCs of differences in tax systems as inappropriate or unfair and the highly engineered and artificial structures that produce some of these arbitrage spreads can have significant economic consequences in one or both of the affected jurisdictions.”).

<sup>14</sup> *Duke of Westminster v Commissioners of Inland Revenue* [1936] AC 1 at 19-21 (Eng.) (“Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”).

<sup>15</sup> Bret N. Bogenschneider, *Professional Ethics for the Tax Lawyer to the Holmesian “Bad Man”*, 49:4 CREIGHTON L. REV. 775 (2016).

<sup>16</sup> *See* European Commission, *The Internal Market: Factual Examples of Double Non-Taxation Cases*, Staff Working Paper 2012, <http://taxpolicy.gov.ie/wp-content/uploads/2012/03/Double-Non-Taxation-Consultation.pdf>; *see also* Adam H. Rosenzweig, *Thinking Outside the (Tax) Treaty*, 2012 WIS. L. REV. 717.

<sup>17</sup> *See e.g.* Michael J. McIntyre, *Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes*, 7 FLA. TAX REV. 622, 629 (2006) (“A transfer-pricing case could result in double non-taxation when a high-tax country has a tax treaty with a low-tax country. In such circumstances, a resident of the low-tax country would be inclined to allocate as little income as possible to the high-tax country and as much income as possible to the low-tax country. The tax officials in the high-tax country might disagree with that allocation, and if the tax officials in the low-tax country supported the position of the taxpayer in a competent-authority proceeding, there is at least some chance that the matter would not get resolved.”).

<sup>18</sup> Avi-Yonah at 312.

<sup>19</sup> Internal Revenue Code §7701.

there is no residual U.S. tax collected on profits since the un-taxed (or very low-taxed profits) are never repatriated back to the United States.

The form of Double Non-Taxation of particular interest for purposes of this paper arises in the situation where a provision of tax treaty between nations (i.e., a “Convention for the Avoidance of Double Taxation between Country X and Country Y”)<sup>20</sup> is claimed by a U.S. multinational to achieve double-exemption from taxation in both countries party to the tax treaty. As such, the tax treaty which was intended to avoid double taxation, in actual effect leads to Double Non-Taxation where neither the country of *source* nor the country of *residence* is able to tax the profits of the multinational because of the application of the tax treaty.<sup>21</sup> A classic example of using a hybrid mismatch and a tax treaty in the U.S. context was described by Streng in detail as follows:

From the taxpayer's (and tax planner's) perspective, the objective, of course, is (1) to not only avoid economic double taxation but also (2) to achieve "double non-taxation." This means incurring no tax on the income derived from a particular cross-border transaction, achieved through exploiting gaps between the tax structures in the two countries which are the parties to the tax treaty. Thus, in some situations no tax is actually imposed on certain types of income by either the source country or the residence country. For investors coming into the United States this can be possibly achieved when the foreign investor importing the capital into the United States operates through a reverse hybrid structure (that is, a corporation in the United States and a pass through in the country of residence). For government tax policy specialists, the inquiry must be whether "double non-taxation" should be indirectly authorized through gaps in an income tax treaty.<sup>22</sup>

Although the specific provision of the tax treaty utilized to achieve double exemption (or effective non-taxation with transfer pricing methods) may vary in actual practice, such a result is very real and is an omnipresent aspect of international tax practice.

**b. Ethical implications When the Tax Lawyer “Switches Hats”.**

Judge Learned Hand (and Lord Tomlin in the United Kingdom) each famously remarked that taxpayers have a right to engage in tax avoidance planning where the facts are re-arranged in some manner to arrive at a more favorable tax result. Judge Hand wrote:

Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. . . . Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands.<sup>23</sup>

However, any right of the client to manufacture facts was limited to restructurings that led to determinate tax avoidance as a matter of law. The comments of Judge Hand were directed toward such *determinative* tax avoidance. In contrast, moving beyond the *manufacture of facts* to the *restructuring* of facts merely to raise a legal challenge that might or might not be reviewed (depending on the results of the audit lottery) is not such a determinate situation. This raises the classic ethical issue identified by Geoffrey Hazard of conduct that is *to some degree* illegal.<sup>24</sup> Furthermore, in the situation where the tax lawyer switches “hats” to engage in the “manufacturing” of tax avoidance structures, the functions reverts to that of a

<sup>20</sup> See e.g. U.S. / France Tax Treaty: Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital < <https://www.irs.gov/pub/irs-trty/france.pdf>>.

<sup>21</sup> See generally Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. J. TAX L. 1 (2013/14).

<sup>22</sup> William P. Streng, *U.S. Tax Treaties: Trends, Issues, & Policies in 2006 and Beyond*, 59 SMU L. REV. 853, 874 (2006).

<sup>23</sup> *Comm’r v. Newman*, 150 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting).

<sup>24</sup> See Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Legally Wrongful Conduct?* 35 U. MIAMI L. REV. 669, 679 (1981).

“planner” and not an “advisor”.<sup>25</sup> The ethical issues incumbent to a tax practitioner engaged in the affirmative creation of facts are different than a legal advisor engaged solely in giving legal advice. The tax lawyer as advisor may essentially pretend he does not know the ultimate intent of the client with regard to a particular tax structure, however, the tax lawyer acting as “planner” may not ethically plan with the express purpose of undermining the substance of the tax law.<sup>26</sup>

## II. Background on Tax Treaty Interpretation.

Tax professionals specializing in international tax treaties often speak in terms of “tax treaty interpretation”.<sup>27</sup> Tax treaty interpretation is an art not a science. Ulf Linderfalk wrote: “Despite the existence of Articles 31-33 of the Vienna Convention on the Law of Treaties (VCLT, to some extent, issues of interpretation still have to be resolved at the discretion of the law-applying agents themselves.”<sup>28</sup> The underlying idea of “interpretation” is an aspect of positive law adjudication which is often unfamiliar to U.S.-trained tax professionals. “Interpretation” means that legal analysis involves solely analysis of the positive law, which means here analysis of the legal framework set forth in the definitions and provisions of the tax treaty. So, legal analysis based on anything outside the particular terms and definitions of the tax treaty is greatly discouraged (or effectively proscribed). As such, tax treaty interpretation is potentially an application of Kelsen’s “Pure Theory of Law” where *pure* means just positive law analysis.<sup>29</sup> Hans Kelsen referred to legal interpretation based on anything outside the positive law as “normative” analysis.<sup>30</sup> Fitzmaurice later termed this idea “sociology”, in disparagement of U.S. methods of legal interpretation that are often referred to by legal theorists as various shades of “legal realism”.<sup>31</sup> For this reason, positive law enthusiasts in Europe will sometimes snidely say that U.S.-style legal interpretation is a form of sociology.<sup>32</sup> The role of the adjudicator in rendering decisions in tax cases in common law versus civil law legal systems thereby becomes a relevant issue.<sup>33</sup> Richard Gardiner developed the analogy of tax treaty interpretation as a “crucible” where everything gets throw into the interpretational pot.<sup>34</sup> The “crucible” approach seems apt as it is reflected in the doctrinal sources of law on treaty interpretation applied in further detail here.<sup>35</sup>

<sup>25</sup> See Bret N. Bogenschneider, *Manufactured Factual Indeterminacy and the Globalization of Tax Jurisprudence*, 4:2 UCL J. LAW & JURIS. 250 (2015); Bret N. Bogenschneider, *Factual Indeterminacy in International Tax Law*, 3:1 BRICS LAW J. \_\_ (forthcoming 2016).

<sup>26</sup> See Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 U. KAN. L. REV. 847, 852 (1999) (“[A] client can put a lawyer at risk if the client has committed tax fraud and the tax lawyer’s advice might assist in furthering the fraud.”); Model Rules of Prof’l Conduct preamble & scope § 3 (Am. Bar Ass’n 1983).

<sup>27</sup> See e.g. Michael Lang, *Tax Treaty Interpretation* (Vienna: Kluwer, 2001).

<sup>28</sup> Ulf Linderfalk, *Is Treaty Interpretation an Art or a Science? International Law and Rational Decision Making*, 26 EUROPEAN J. INT’L L. 169, 175 (2015).

<sup>29</sup> See Hans Kelsen, *The Pure Theory of Law* (Knight, tr., 2nd ed., 2005); Hans Kelsen, *The Pure Theory of Law and Analytical Jurisprudence*, 55 HARV. L. REV. 44, 52-3 (1941); Hans Kelsen, *On the Theory of Interpretation*, 10 LEGAL STUDIES 127 (1990).

<sup>30</sup> See generally Christoph Kletzer, *Absolute Positivism*, 42(2) NETH. J. LEGAL PHIL. 89 (2013).

<sup>31</sup> Sir G. Fitzmaurice, *Vae Victis or Woe to the Negotiator? Your Treaty of Our Interpretation of It*, 65 AM. J. INT’L LAW 372 (1971).

<sup>32</sup> See e.g. Margosia Fitzmaurice, *Review of Recent Books on International Law* (Bilder, ed.) (2010) 104 AM. J. INT’L LAW 329; Margosia Fitzmaurice, *Book Review: Richard Gardiner, Treaty Interpretation* 20 EUROPEAN J. INT’L LAW 952 (2008).

<sup>33</sup> See Bret N. Bogenschneider, *Is Tax Law Subordinated to Contract Law in Transfer Pricing Matters?* 7:1 TRANSNAT’L LEGAL THEORY \_\_ (forthcoming 2016).

<sup>34</sup> Richard Gardiner, *Treaty Interpretation*, 2d. (Oxford International Law Library, 2015); see also Margosia Fitzmaurice, *Book Review: Richard Gardiner, Treaty Interpretation*, 20 EUROPEAN J. INT’L L. 952 (2008) (“The International Law Commission names this system of interpretation a “crucible” approach to treaty

For U.S. tax professionals interested in tax treaty interpretation, a potential analogy in interpretational method is tax treaty interpretation is akin to contract interpretation. Here, the “contract” to be interpreted is the treaty—a form of a contract between nation states assigning taxing rights in various circumstances of cross-border activity of individuals and businesses. Hence, professional ethics in tax treaty interpretation is analogous to professional ethics in contract interpretation by persons not party to the contract but for whom the contract will determine some legal right, here the allocation of taxing rights. Various methods might be imagined for the appropriate legal method to be applied to interpret a tax treaty in the situation where two or more provisions of the treaty conflict, because such a conflict between provisions might change the allocation of taxing rights. Of course, a corollary situation often arises in contract interpretation of competing provisions within a contract or a trust agreement. However, business contracts are typically extensive documents hundreds of pages long designed to cover many possible scenarios in a business deal. Yet, tax treaties are very short, often just a few pages. The situation where the treaty says *too much* is very rare. The problem usually encountered in tax treaty interpretation is that the treaty itself says *too little*. In that case, the treaty does not *specifically* cover the situation that arises; thus, any legal debate that ensues is as between separate provisions, each of which might arguably apply to the current situation. In other cases, such as with the taxation of intangibles or taxing issues arising in the digital economy interpreted under a tax treaty signed in the Nineteenth century, it is actually impossible that the signers of the tax treaty could have intended to cover such a situation with the terms of a particular provision.

The Vienna Convention on the Law of Treaties (“VCLT”) set out to provide the applicable methodology of legal interpretation for treaties, including treaties for the avoidance of double taxation.<sup>36</sup> Since tax treaties are highly abbreviated legal documents, the interpretational analysis often resembles U.S. methods of Constitutional interpretation.<sup>37</sup> With Constitutional disagreements, the meanings of provisions must be interpreted, and the debate then takes the form of a debate between textualism, original intent, the idea of a “living” document, and many others.<sup>38</sup> The VCLT established that tax treaties are not treated as “living” documents (thus separating tax treaty interpretation from U.S. methods of Constitutional interpretation).<sup>39</sup> So, if domestic tax law changes after the signing of the tax treaty, resulting in the potential for Double Non-Taxation under a method of tax treaty formalism, the outcome of Double Non-Taxation is taken as perfectly fine. This is perhaps the quintessential example, notwithstanding it seems preposterous that a tax treaty entitled “for the avoidance of double taxation” might result in Double Non-Taxation. Notably, some foreign courts engaged in tax treaty interpretation have openly mocked such an outcome as “anathema”.<sup>40</sup> Indeed, it is worth noting here that the results of a textualist approach to treaty interpretation might also be viewed by some U.S. Federal courts as anathema, especially if application of the method resulted in Double Non-Taxation. The Vogel/Rust treatise on treaty

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interpretation which is describes as follows: “All various elements, as they were present in any given case, would be thrown into the crucible, and their interpretation would give the legally relevant interpretation.”).

<sup>35</sup> See Klaus Vogel on Double Taxation Conventions, (Reimer & Rust, eds.) (4th ed.) (Netherlands: Kluwer, 2015).

<sup>36</sup> Vienna Convention on the Law of Treaties (1969), Articles 31 and 32.

<[treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf](http://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf)>.

<sup>37</sup> See generally David A. Strauss, *Common Law Constitutional Interpretation*, 63 U. CHICAGO L. REV. 877 (1996)

<sup>38</sup> See W.H. Rehnquist, *The Notion of a Living Constitution*, 54 TEX. L. REV. 693 (1976).

<sup>39</sup> See Lang (2001), *supra* note 27.

<sup>40</sup> Michael Lang, IFA General Report 73, 87 (2004) (“Above all, this does not give rise to any obligation pursuant to which contracting states must actually exercise the rights to tax assigned to them. Although double non-taxation is occasionally described as “unthinkable or an anathema”... DTCs require a rather sober approach.”) citing *The Estate of Michel Hausmann v. Her Majesty The Queen* 97-1767(IT) (1998), 1998 Can. Tax Ct. (Tax Court of Canada).

interpretation describes U.S. methods of substantive treaty interpretation as “erroneous”, citing the 1996 IFA General Report.<sup>41</sup>

The VCLT Article 31 and 32 attempted to address some of the problems of interpretational problems in tax treaties with reference to the context.<sup>42</sup> Tax treaty scholars accordingly set out to identify what is meant by the idea of “context”-ualism in Article 31 of the VCLT.<sup>43</sup> Rust/Vogel explain as follows:

The older view that primarily looked for the subjective intent of the parties to the treaty is thereby rejected... [T]he intention of the parties, according to Article 31 VCLT and § 325 of the Restatement Third, is only significant to the degree to which it has been expressed in the text of the agreement... It is even less acceptable for a court to use as a basis of interpretation that which it presumes the parties must have intended. This is true even in cases where the interpretation of the treaty according to its working may lead to a non-logical result.<sup>44</sup>

However, such an approach at least arguably abandons any attempt at coherency because a legal method of “*text*”-ualism obviously cannot simultaneously mean “*context*”-ualism. As a matter of legal method, the words “text” and “context” are antonyms. This is the equivalent of giving instructions for tax treaty interpretation by saying: *Look solely to the words to determine the meaning, unless the circumstances indicate the words are insufficient to determine the meaning.*<sup>45</sup> Yet, this is the applicable legal method of tax treaty interpretation under the VCLT.

As a practical matter, legislative history is typically *not* taken into account in tax treaty interpretation, but this is not always the case.<sup>46</sup> Hence, tax treaty analysis may render radically inapposite outcomes on many issues *including* the potential for Double Non-Taxation. However, many European nations keen to attract “mobile capital”<sup>47</sup> from U.S. multinationals (by establishing themselves as favorable tax regimes) openly foster treaty networks to tacitly encourage Double Non-Taxation of multinational firms. Obviously, the

<sup>41</sup> Vogel/Rust at 39, footnote 131.

<sup>42</sup> VCLT Article 31 (“General Rule of Interpretation. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”); Article 32 (“Supplementary means of interpretation. Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances... when the interpretation... leaves the meaning ambiguous or obscure”).

<sup>43</sup> Edwin van der Bruggen, *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties*, [2003] EUROPEAN TAXATION 142.

<sup>44</sup> Rust/Vogel at 39.

<sup>45</sup> The usage of strictly formalized interpretational rules by Union generals in apparent defiance of common sense is thought by many military historians to have contributed to the loss of the Second Battle of Bull Run against the Confederate army resulting in a disastrous prolongation of the Civil War. The Union Generals John McDowell and John Pope gave conflicting orders during the battle which were interpreted by subordinates (subsequently found to have been *correctly* interpreted by the subordinates) according to the U.S. Army’s “rule of good discipline” then abandoned after the battle. This method for the hierarchy of interpretation of written orders as explained by Donald Jermann was as follows: “One must obey the last order received by a competent authority. Thus, if McDowell were to give an order, even if it conflicted with the order he received from Pope, Porter would have to obey it. And, as might be expected, McDowell did begin ordering Porter.” Donald Jermann, *Civil War Battlefield Orders Gone Awry: The Written Word and its Consequences in 13 Engagements* (McFarland & Co., 2012).

<sup>46</sup> See Rust/Vogel at 40 (“In contrast, Article 32 VCLT states that ‘accompanying materials’ that were created in the context of the treaty negotiations, such as elaborations on the treaty, supporting documents, position papers, etc., may only be referred to as a supplementary source if they confirm the interpretation resulting under Article 31 or in cases of doubt.”).

<sup>47</sup> See Rosanne Altshuler, Benjamin H. Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355 (2010)

customs and traditions of tax treaty interpretation allow for Double Non-Taxation of multinational firms in those jurisdictions and Double Non-Taxation functions effectively as the default rule as a matter of European tax treaty interpretation under the VCLT.

The U.S. delegation to the Vienna Convention led by Myers McDougal was outvoted on the issue and, accordingly, the United States did not ratify the Vienna Convention.<sup>48</sup> Notwithstanding, historical U.S. ideas about treaty interpretation have been reinvigorated in recent years based on experiential learning on drafting techniques for tax avoidance rules.<sup>49</sup>

**a. OECD Model Treaty and Interpretational Norms.**

The introductory section to this article provided some background on international tax planning including an explanation of the technical concept of Double Non-Taxation. To summarize, once the critical importance of the “check-the-box” regulations to international tax planning emerged, a major debate then erupted on whether Double Non-Taxation was an appropriate interpretation of *any* tax treaty. The elimination of double taxation and planning toward Double Non-Taxation are obviously not the same. Tax treaties deal with the avoidance of double taxation, and at least ostensibly, are not intended to be used as a planning tool for multinationals toward Double Non-Taxation. The debate culminated in a great deal of tax scholarship including reports from dozens of nations regarding the experience of many nations with their respective tax treaties used as a means to achieve Double Non-Taxation, which is described in the International Fiscal Association (“IFA”) Report of 2004.<sup>50</sup> The IFA report included an extensive discussion by Michael Lang of the Double Non-Taxation issue as it relates to tax treaty interpretation.<sup>51</sup> The arguments presented in Lang’s IFA General Report are summarized here with an updated response in light of subsequent developments including the OECD BEPS initiative.

The Lang IFA General Report of 2004 is a full-throated defense of traditional methods of tax treaty interpretation that may lead to Double Non-Taxation for multinational firms. As explained in the preceding section, a textualist method based in part on Kelsen’s *Pure Theory of Law* does not look to the potential outcome as a matter of legal interpretation. Lang remarked as to Double Non-Taxation as follows:

In all these provisions, the contracting states not only intentionally tolerated but even pursued that the item of income is not taxed anywhere. A bilateral convention is based on the laws applicable in the two states at the time of its conclusion, which in correlation with the DTC leads to the emergence of double non-taxation.<sup>52</sup>

In actual practice, tax treaty interpretation is accordingly a hybrid blend of interpretational methods that seem to be based on customs and tradition premised on historical ideas, such as those of Klaus Vogel.<sup>53</sup> As a prime illustration, in the IFA General Report of 2004, Lang avers that tax treaty interpretation should not incorporate any legal methodology apart from the text of the treaty and further the OECD model convention for the same proposition.<sup>54</sup> He wrote:

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<sup>48</sup> See Julian Davis Mortenson, *The Travaux de Travaux: Is the Vienna Convention Hostile to Drafting History?* 107 AM. J. INT’L LAW 780 (2013).

<sup>49</sup> See Myers McDougal, et al., *The Interpretation of Agreements and World Public Order* (West Haven: Yale Univ. Press, 1967).

<sup>50</sup> Lang (2004) *supra* note 40.

<sup>51</sup> *Id.* at 81 (“This suggests that, for this reason alone, it cannot generally be assumed that DTCs aim at preventing double non-taxation. The reporters were accordingly critical as they pointed out each with a different emphasis that DTCs are by no means based on the idea of preventing double non-taxation and that this is true only for certain cases at the most.”).

<sup>52</sup> *Id.* at 83.

<sup>53</sup> See Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT’L TAX & BUS. LAW 1 (1986).

<sup>54</sup> Lang (2004) at 99 (“The OECD Committee on Fiscal Affairs believes, however, that qualification conflicts caused by a different interpretation of the facts or by a different interpretation of the convention cannot be

According to this opinion, the phrase “unless the context otherwise requires” is almost of no importance. At the other end of the range stands the opinion also shared by the general reporter, according to which the national law of the applying state must be applied only “unless the context otherwise requires”, and the context of the convention always provides for a solution so that a recourse to national law is practically never necessary.<sup>55</sup>

The OECD model tax treaty is repeatedly cited as a reference document for positive law interpretation of existing tax treaties. So, by referencing the OECD model treaty as a matter of positive law interpretation, the usage of a policy-malleable document as source law (or “soft law” initiatives) amount to a back-door means of incorporating tax policy into tax treaty interpretation.<sup>56</sup> Notably, Rust/Vogel welcomed the use of OECD commentary as establishing an interpretation norm:

[T]o the extent that a specific technical language has developed in certain specialized areas, such as tax law, this is the ‘ordinary’ usage within the meaning of Article 31(1) VCLT. This is particularly true for those terms which, under the influence of the OECD Model Convention and its Commentary, have since developed into an international tax language.<sup>57</sup>

The technical arguments given by Lang in favor of tax treaties used as a means to achieve Double Non-Taxation are given here in bullet points (and then discussed in detail in the following paragraphs):

- i. Tax treaties are intended solely for the avoidance of avoid double taxation, so the prevention of Double Non-Taxation is outside the scope of the treaty (i.e., Double Non-Taxation results are generally a “null” result, or, not covered by the positive law, which here is the treaty provisions).<sup>58</sup>
- ii. Some tax treaties expressly allow for Double Non-Taxation.<sup>59</sup>
- iii. Some tax treaties implicitly allow for Double Non-Taxation.<sup>60</sup>
- iv. In some cases, legal interpretation under domestic laws leads to Double Non-Taxation even with the consistent application of a tax treaty, so the cause of Double Non-Taxation must be domestic tax law and not the tax treaty itself.<sup>61</sup>
- v. Even where the title of a tax treaty explicitly states that the purpose of the convention is to disallow Double Non-Taxation, this stated intent is not important.<sup>62</sup> Further,

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solved by way of a new interpretation of the existing provision of article 23A(1) OECD model convention but require an express regulation that can only have an effect if and to the extent it becomes part of the DTC.”).

<sup>55</sup> *Id.* at 98.

<sup>56</sup> See Hugh J. Ault, *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOK. J. INT’L L. 757 (2009); Allison Christians, *Sovereignty, Taxation and Social Contract*, 18 MINN. J. INT’L L. 99 (2009).

<sup>57</sup> Rust/Vogel at p. 39 citing *Thiel v. FCT*, 21 ATR 531, 537 (High Court of Australia, 1990); see also Bret N. Bogenschneider, *Wittgenstein on Why Tax Law is Comprehensible*, [2015] BRITISH TAX REV. 252.

<sup>58</sup> Lang (2004) at 86 (“The considerations presented in this report show that DTCs by no means serve the general purpose of preventing double non-taxation. Instead, it seems that there is not a single case in which double non-taxation triggered by a unilateral waiver of the right to tax by both sides is in violation of the DTC.”).

<sup>59</sup> *Id.* at 82 (“Although several tax sparing and matching credit provisions do not necessarily result in double non-taxation, DTCs deliberately permit it.”).

<sup>60</sup> *Id.* at 85 (“In all these cases, however, it must be assumed that the contracting states accepted that the national tax systems are subject to change and that a contracting state may at a later stage decide not to exercise a right to tax assigned to it by the convention.”).

<sup>61</sup> *Id.* at 86 (“Therefore, if both contracting parties do not tax certain cases in their national law, this does not by any means contradict the objective and purpose of the DTC.”).

<sup>62</sup> *Id.* at 84 (“Double non-taxation is even possible in those cases in which the title of the convention, the preamble, or its materials indicate that the conventions serve to prevent circumvention or abuse.”) citing *Lamesa Holdings BV v. Commissioners of Taxation* [1999] FCA 612 (Australian Federal Court).

- various common tax treaty provisions that ostensibly seem to be aimed at preventing Double Non-Taxation are not important because a common strategy or the most effective strategy is not used.<sup>63</sup>
- vi. The purpose of an exemption method to avoid double taxation embodied in a tax treaty is to place cross-border investment on a neutral footing and to avoid distortions of competition, so Double Non-Taxation might represent a feasible means to prevent the distortion of competition if we looked only at taxation in one country at a time.<sup>64</sup>
  - vii. Various attempts to prevent Double Non-Taxation through the administration by taxing authorities represent a violation of treaty provisions under VCLT treaty interpretational norms.<sup>65</sup>
  - viii. The OECD has proposed a specific revision to its model treaty in Article 23A(4) aimed at preventing Double Non-Taxation, so that OECD proposal should be the end of the Double Non-Taxation analysis; scholars should now stop focusing on the issue of Double Non-Taxation.<sup>66</sup>
  - ix. Even the U.S. method of foreign tax credit (not exemption) could lead to Double Non-Taxation in some cases, so the possibility of Double Non-Taxation cannot be eliminated entirely.<sup>67</sup>
  - x. Even the U.S. (plus, French and German) practice of incorporating “subject to tax” clauses into the standard tax treaty require interpretation in practice, so the possibility of Double Non-Taxation cannot be eliminated entirely.<sup>68</sup>
- b. Technical Analysis of Treaty-based Double Non-Taxation.**

The general conclusion of the IFA Report of 2004 is as follows: “If the contracting states want to ensure that the convention does not lead to cases of double non-taxation in the future, this cannot be achieved by way of interpretation.”<sup>69</sup> Accordingly, interpretation should not change the ultimate result in the form of Double Non-Taxation. The purpose of this section is to address each of the technical points as summarized in the IFA General Report of 2004 to establish that treaty-based Double Non-Taxation is a form of aggressive tax

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<sup>63</sup> *Id.* at 118 (“Recent treaty practices, however, show that an increasing number of states incorporate specific provisions in their network of treaties in order to prevent double non-taxation in precisely described situations. The bilateral provisions are completely different. Most states formulate these separately for each DTC. It is often not possible to detect a common strategy. If the states are concerned that double non-taxation may ensue from a lack of taxation in the source state, a shift to the credit method is particularly suitable for preventing double non-taxation without conflicts.”).

<sup>64</sup> *Id.* at 83 (“After all, within the scope of application of the exemption method, those who work or invest in the other state are to be put on an equal footing with the competitors that operate from within the other state. If these competitors are not taxed there, it is only logical that cross-border activities will be treated the same way to avoid any distortions of competition.”).

<sup>65</sup> *Id.* at 111 (“In some states, the term subject to tax does not apply if the income is not really subjected to taxation. It is questionable whether a subject-to-tax clause is applied even if the reason for not taxing the income does not lie in national law but results from the fact that the income is not covered due to a different qualification on the level of treaty law.”).

<sup>66</sup> *Id.* at 118 (“In a wider context, one must not forget to point out that the focus of the work of the OECD and the treaty negotiators should lie elsewhere. By inserting article 23A(4) of the OECD model convention in 2000, the OECD Committee on Fiscal Affairs has already created an express provision in order to prevent double nontaxation in certain qualification conflicts.”).

<sup>67</sup> *Id.* at 105 (“The most elegant way of preventing double non-taxation is to apply the credit method. This method, however, can only produce the desired result if non-taxation is triggered by the source state. Moreover, it cannot protect the source state against the state of residence not levying taxes.”).

<sup>68</sup> *Id.* at 92 (“The French tax authorities generally deny residence when the recipient of income is not effectively subject to tax.”); *Id.* at 104 (“Another example is Germany, which consistently makes the application of the exemption method subject to reservations in all its DTCs. It regularly agrees on switch-over clauses that provide for a shift from the exemption to the credit method in case of income subject to low or no taxation at all.”).

<sup>69</sup> *Id.* at 85.

avoidance planning and not something merely incumbent to tax treaties by design. The general idea underlying this analysis is whether any of the technical claims about international methods of tax treaty interpretation impact the professional ethical obligations of U.S. tax professionals engaged in tax treaty interpretation.

(i) *Double Non-Taxation is outside the scope of the typical tax treaty on the avoidance of double taxation.* An interpretational approach based on Kelsenian formalism ought to say that a treaty for the avoidance of double taxation covers only situations of possible *double taxation* within the framework of the treaty, and not, situations of Double Non-Taxation not covered by the framework of the treaty. The broader proposal that the tax treaty covers any manner of taxation represents an expansive view of the scope of the applicable treaty – the extensive gaps in which are then to be filled in by the treaty interpreter. An analogy might be given to a rulebook for the game of soccer. Simply put, even if the soccer rulebook (by analogy the tax treaty) has an extensive discussion of how to kick in the game of soccer that does not render it the *exclusive source* of positive knowledge about that subject of kicking. Rather, the tax treaty would itself only cover tax issues arising in the context of double taxation, and nothing else. That should be the formalist view of Double Non-Taxation in tax treaty interpretation, which is amazingly nowhere to be found in the IFA General Report of 2004.

The contrary idea developed by Lang in the IFA General Report of 2004 is that the treaty is essentially a treaty about all matters of taxation irrespective of whether such matters fall within the stated object or framework of the tax treaty. This renders tax treaty interpretation the *de facto* source of potentially all knowledge about international taxation. There are many reasons as a matter of legal theory not to proceed with this method of legal knowledge about international taxation, perhaps the most obvious reason being that a domestic tax code is often thousands of pages, and a tax treaty might be around 10 pages. In a 10-page document there will necessarily be many gaps, including gaps related to various aspects of Double Non-Taxation. In that case, it looks like a form of sociology for the tax treaty interpreter to fill in the gaps and to then say that Double Non-Taxation must be allowable under tax treaties.<sup>70</sup> In other words, a 10-page tax treaty document would certainly seem to provide the rules for the avoidance of double taxation, and not all tax rules. A formalist method of interpretation would then require that the 10-page tax treaty be interpreted solely with respect to its own object and purpose relating to avoidance of double taxation and thereby excluding general or exclusive source knowledge of all matters of Double Non-Taxation.

(ii) *Some tax treaties expressly allow Double Non-Taxation.* A provision allowing Double Non-Taxation is indicative of a general rule that Double Non-Taxation is not allowable, and not vice versa. If the general rule were that Double Non-Taxation ought to result, then the treaty obviously would not need a rule expressly allowing Double Non-Taxation.

(iii) *Some tax treaties implicitly allow Double Non-Taxation.* If Double Non-Taxation were the general international norm, then extensive planning by multinational firms would not be necessary to achieve Double Non-Taxation via particular treaty networks. Obviously, extensive planning is required to achieve Double Non-Taxation. If a particular treaty implicitly allows for Double Non-Taxation, this is an indication of deviance from international norms and not the norm itself.

(iv) *Domestic tax law is the cause of Double Non-Taxation.* This argument represents a form of logical fallacy in terms of the drafting of positive law. The object and purpose of a domestic positive law of taxation cannot be to achieve Double Non-Taxation by tacit

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<sup>70</sup> For a detailed discussion of the use of an internal perspective in Continental European methods of legal interpretation see: Mikhail Antonov, *On Systemicity of Law and on "Systemic" Notions in Legal Science*, [2014] LEGAL STUDIES 24.

acceptance of non-taxation in another state. For example, if an existing tax treaty assigns the taxing right to the other state (which does not exercise the taxing right), this provision to not tax in the domestic state under local law relates solely to taxation in the domestic state. If domestic law were intended to also be international tax law, there would be no need for the tax treaty. As a theoretical matter, it is conceivable (in a hypothetical universe without Constitutional restrictions) that nations could structure their domestic tax laws to achieve the same result as under a network of tax treaties. However, that is not the world of international taxation as we currently find it, so we would not say that domestic tax law is the cause of Double Non-Taxation (double exemption) between signatories to a tax treaty; in other words, the tax treaty is always taken to be the *proximate cause* of Double Non-Taxation and Lang's suggestion to the contrary is fallacy.

(v) *Treaty provisions aimed at preventing Double Non-Taxation are not important.* Not at all. A tax treaty for the avoidance of double taxation could of course include a provision that says the document should not be construed so as to allow for Double Non-Taxation. This is especially true after the issuance of the "check the box" regulations, where it became clear that tax treaties were increasingly being used as a means to achieve Double Non-Taxation.

(vi) *Double Non-Taxation might prevent economic distortion.* Not at all. Double Non-Taxation is an economic distortion in favor of firms able to achieve non-taxation in comparison to firms that must pay tax.<sup>71</sup> The idea of economic distortion is not a "no-tax" neutrality principle, except perhaps in the imagination of Libertarian theorists.

(vii) *Some attempts to combat Double Non-Taxation by tax administration violate treaty protections.* Agreed. Any express violation (or administrative defeat) of treaty protections is a violation of a treaty. The ends do not justify the means. For instance, if a particular treaty is being used to achieve Double Non-Taxation (for example, at the expense of a source state), a state ought to be able to cancel the treaty with the opposing nation with the prospect of re-negotiating a replacement treaty. The practical inability to re-negotiate old tax treaties likely raises many administrative problems, but this factor does not represent a justification for Double Non-Taxation. The observation of administrative violations seeking to deny Double Non-Taxation merely proves that Double Non-Taxation is a serious problem in tax treaty interpretation.

(viii) *The OECD proposals (before BEPS) should be sufficient to address treaty-based Double Non-Taxation.* This argument was vitiated by the OECD BEPS initiative and will not be addressed here.

(ix) *The foreign tax credit mechanism in U.S. tax treaties is not sufficient to prevent all types of Double Non-Taxation.* If a treaty is designed so as to defeat Double Non-Taxation, the inability of the design to stop all forms of Double Non-Taxation does not imply that the Double Non-Taxation must therefore be the international norm. For example, if an ocean-going ship is expressly designed so as not to leak in heavy seas, the act of subsequently plugging leaks in the hull of the ship does not mean attempting to design the ship to avoid leaks was wrong or impossible.

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<sup>71</sup> See Avi-Yonah at 310 ("The single tax principle states that cross-border income should be taxed once at the rate determined by the benefits principle. In other words, cross-border income should be taxed only once at the source-country rate for active income and at the residence-country rate for passive income. But if the prefer-red country (i.e., source for active, and residence for passive) does not tax, it is incumbent upon the other country to do so because otherwise, I argued in my article, double non-taxation would result, which is just as damaging as double taxation. This argument remains hugely controversial. While there are indications that the single tax principle was the idea underlying the adoption of the foreign tax credit by the United States in 1918, as far as tax treaties are concerned, the United States did not accept the single tax principle until more recent times."); see also Bret N. Bogenschneider, *A Theory of Small Business Tax Neutrality*, 15 FSU Bus. Rev. 33 (2016).

(x) A “subject to tax” clause as characteristic of U.S. tax treaties is not sufficient to prevent all types of Double Non-Taxation. The “subject to tax” clause entails a principal aspect of U.S. tax treaties. All tax professionals have an obligation to perform a substantive review as a matter of tax treaty interpretation for U.S. tax treaties. And, as explained here, the seeking out of indeterminacy to achieve Double Non-Taxation under any treaty raises an ethical concern, in particular for U.S. tax professionals.

**c. Non-Standard U.S. Methods of Tax Treaty Interpretation.**

Tax treaties are approached differently by the United States in comparison to other nations both in respect to drafting and interpretation. This may be changing as the OECD has moved in the direction of the U.S. methods of tax treaty interpretation as reflected in the commentary to the OECD Model Treaty. The different methodological approach applied with respect to U.S. treaties is due to at least the following four differences. First, in 1981, the U.S. Senate refused to ratify the proposed tax treaty with Argentina.<sup>72</sup> This event represented at least a partial acceptance of the “single tax principle”, as discussed above. Second, the United States has expressly rejected the idea of the “Treaty with the World”.<sup>73</sup> As mentioned by David Rosenbloom, the “Treaty with the World” concept refers to the potential for multinationals to form a legal entity in a particular nation specifically to take advantage of a favorable treaty network.<sup>74</sup> So, in the absence of any limitation, multinationals could potentially obtain the benefits of the most favorable treaty negotiated by the United States with *any* other nation. To avoid this result, the United States contemplated a limit on the availability of treaty benefits. As such, the claimant legal entity is allowed to claim U.S. treaty benefits solely to the extent of a bona fide business activity in the counterparty nation.<sup>75</sup> This rule has the effect of forcing a degree of economic substance onto tax treaty interpretation. Third, the U.S. Treasury includes an express “Limitation on Benefits” (“LOB”) provision into the U.S. Model Treaty in Article 22.<sup>76</sup> According to such LOB provision, entitlement to beneficial exemption under a provision of the treaty is contingent on the exercise of taxing rights by the other nation on a particular item of income. Fourth, the U.S. applies in its treaties and tax law a credit mechanism (not an exemption) for the avoidance of double taxation on foreign profits. Such foreign tax credit method typically adopts the “single tax principle”, by definition. However, this is not the method for all categories of income, such as the taxation of interest and dividends to which the U.S. allows for an exemption on tax withholding. In some important situations, double tax exemption could still apply even under a U.S. tax treaty, just as Lang correctly pointed out in the IFA General Report of 2004.

<sup>72</sup> Avi-Yonah at 316-7 (“Additionally, the LOB provided that treaty benefits will not be available to corporations entitled to a significantly lower tax rate in their country of residence. Subsequent to the 1981 U.S. Model Tax Treaty, the LOB provision became a standard part of all U.S. treaties. Indeed, ever since the Senate in 1981 refused to ratify the treaty with Argentina unless it included an LOB, it has been clear that no U.S. treaty will be ratified without an LOB. And in 1986, Congress created a treaty override by adopting a “qualified resident” test (a simple LOB) in the context of the branch profits tax, which made it applicable to all U.S. treaties, including the majority that did not yet have an LOB provision.”).

<sup>73</sup> Avi-Yonah at 318 (“While Rosenbloom later mentioned the ‘treaty with the world’ problem and the revenue impact of allowing third-country investors to benefit from a treaty, the principal thrust of these observations is that the United States (as a source jurisdiction) should not reduce its withholding tax, unless it has some reasonable assurance that the income will be subject to tax on a residence basis.”).

<sup>74</sup> See David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT’L L. 359 (1981).

<sup>75</sup> See Lang (2004) at 108 (“Pursuant to some DTCs – especially those concluded by the United States the reduction of the withholding tax particularly for dividends, interest and royalties belonging to a permanent establishment located in a third state depends on the level of the total tax burden in the state of residence and in the third state.”).

<sup>76</sup> U.S. Treasury Model Treaty Article 22 < [www.treasury.gov/resource-center/tax-policy/treaties](http://www.treasury.gov/resource-center/tax-policy/treaties)>.

### III. Ethical Considerations in Tax Treaty Planning by U.S. Tax Professionals.

Although tax treaty interpretation is an art, there are nonetheless ethical boundaries implicit to tax treaty interpretation. The ethical considerations for tax treaty planning by U.S. tax professionals are divided here as between interpretation of U.S. tax treaties (to which the United States is a signatory) and foreign tax treaties. Of course, in-house tax professionals of multinational firms must be familiar with both types of treaties and methods of interpretation. This is true, notwithstanding that the form and substantive analysis of the respective treaties may be very different. A unique aspect of tax treaty interpretation for U.S. tax professionals is accordingly that the method of interpretation ostensibly changes depending on the treaty subject to interpretation. At minimum, this represents an extraordinary professional challenge for U.S. tax lawyers as lawyers do not typically switch the operant method of acting as a lawyer.

As a matter of substance, Double Non-Taxation cannot *always* be the outcome of treaty interpretation. Vogel/Rust seem to view this observation as the incorporation of an anti-abuse rule into treaties in violation of basic principles of positive law. But, this is not entirely correct. The U.S. method of taking into account the economic substance of an arrangement (and, thereby to require a business purpose for a transaction) is a substantive method of interpretation under the common law and not a GAAR. Vogel/Rust reject the idea of 'economic substance' as part of the method of treaty interpretation in the context of conduit entities.<sup>77</sup>

#### a. The Ethics of U.S. Tax Treaty Planning in light of Limitation-on-Benefit Clauses.

At least with respect to U.S. treaties, the tax practitioner should apply, in part, a substantive method of interpretation. Such U.S. methods of treaty drafting and interpretation potentially limit the availability of treaty benefits in many cases. As a practical matter, such a substantive review entails the additional interpretational steps. The incorporation of new steps into the customs of treaty interpretation has been the subject of much controversy in Europe, as the OECD has recently moved toward U.S. methods of treaty drafting. Of particular significance, the "subject to tax" clause characteristic of U.S. treaties requires a substantive review of the foreign tax treatment of the transaction to determine the application of the U.S. treaty provisions. Another issue is the applicability of "triangular" treaty arrangements where the treaty network of a third country is incorporated within a planning structure to obtain the benefit of a favorable treaty network, and to which the U.S. interpretational rules deny treaty benefits.<sup>78</sup>

An issue of professional ethics may thus arise then for the U.S. tax professional if he fails to apply the U.S. method of treaty interpretation in reviewing the application of a U.S. treaty, and instead proceeds in a highly formalized manner characteristic of traditional European methods of treaty interpretation. One obvious means to do this might be to fail to take into account the "subject to tax" clause at all. However, the more difficult question is marginal tax treaty planning where formalistic plans might be still used to defeat the "subject to tax" clause by using a hybrid entity (where a legal entity is ostensibly subject to tax in form, but not in substance). The U.S. tax lawyer would then take the position (unlikely to

<sup>77</sup> Vogel/Rust at 913 ("This requires both a legal and factual analysis. A lack of 'economic substance' of a conduit beyond its lending activity may thus be relevant, but should not, in and of itself, lead to a denial of beneficial ownership. As there is a danger that certain back-to-back arrangements cannot be tackled through the concept of beneficial ownership, a number of tax treaties include specific clauses to deal with them.").

<sup>78</sup> See Romero J.S. Tavares, *The "Active Trade or Business" Exception of the Limitation on Benefits Clause*, in Lang, M., et al., "Base Erosion and Profit Shifting: The Proposals to Revise the OECD Model Convention", IBFD (2015) ("The general policy of the LOB rule is that treaty entitlement should not typically be granted in triangular arrangements, given that treaties are designed to be bilateral instruments founded on principles of reciprocity.") citing U.S. Department of the Treasury, "Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties" (2007).

ever be challenged by the taxing authorities) that formal planning yields application of the tax treaty and, thus, claim the tax benefits under that assumption (hoping for the best). If this is done as part of the creation of an artificial structure designed by the tax lawyer for tax avoidance, it is an illustration of “switching hats” from legal advisor to planner in order to “manufacture” legal indeterminacy using tax treaties. Such treaty planning raises an issue of professional ethics because the U.S. tax lawyer ostensibly planned a means to undermine the substantive aspects of the U.S. treaty using formalistic methods not allowed in the substantive interpretational method for U.S. treaties. A similar example often occurs based on European tax planning premised on splitting legal and beneficial ownership of assets for tax purposes.<sup>79</sup> And, similar to the substantive aspects of tax treaty interpretation, the United States generally does not recognize beneficial ownership splitting as a matter of U.S. tax laws. The use of such tax planning would represent an ethical issue for the U.S. tax lawyer.

**b. The Ethics of (Double-Exemption) Foreign Treaty Planning after BEPS.**

The next question relates to the professional ethical considerations of a U.S. lawyer interpreting foreign laws or treaties in a matter that would be proscribed under U.S. law and methods. In other words, to what extent may the U.S. lawyer switch methods when he switches from interpreting U.S. law to interpreting foreign law. In practical terms, at least with respect to the interpretation of foreign treaties, the tax practitioner would often apply a highly formalized method often without respect to the substance. To set the stage then, one day the U.S. tax lawyer working in-house for a multinational firm would be obliged to interpret a U.S. tax treaty using a substantive method, and then perhaps the next day, the U.S. tax lawyer would be obliged to interpret a foreign tax treaty using a formalist method. The question of legal methodology stated precisely is whether there is a standard of law such as the VCLT that provides one method to rule them all, or whether the method arises from the treaty itself based on the provisions in the treaty. As a matter of professional ethics, if there is an international method of treaty interpretation, then the U.S. tax lawyer might be obliged to follow it *all* the time.

In the IFA General Report of 2004 and elsewhere, Lang expressly denied that any method of legal interpretation was applicable in tax treaties to avoid this problem.<sup>80</sup> Lang thereby determined that Double Non-Taxation was allowable (or even encouraged) as a matter of treaty interpretation. Yet, recent OECD actions with respect to tax treaties imply that the interpretational method to arrive at that outcome is changing even in Europe. If so, that change could result in the inapposite conclusion that treaty interpretation affirmatively requires a substantive review more consistent with U.S. methods of treaty interpretation. This approach might effectively foreclose Double Non-Taxation as a matter of tax treaty interpretation. As a matter of professional ethics, tax professionals whether U.S. or otherwise, would then be obliged to perform a substantive review and not claim treaty benefits based on highly formalized legal structures. Finally, the OECD pronouncement in BEPS Action 6 relates to tax treaties. In proposed paragraph 63 of the commentary the OECD commentary, there clearly must be a no-tax business reason for the treaty benefits to be obtained<sup>81</sup> This

<sup>79</sup> See Yariv Brauner, *Beneficial Ownership in and outside US Treaties*, in Lang, M. et al., “Beneficial Ownership: Recent Trends”, IBFD (2013) at 157; see also Rust/Vogel 908 (“Some treaties refer in Article 11(1) OECD and UN Model Convention to interest paid to the ‘beneficial owner’ who is a resident of the other Contracting State, in particular when they follow more closely the US Model Convention, which contains such reference (on the definition of ‘beneficial ownership’)”).

<sup>80</sup> See Michael Lang & Florian Brugger, *The Role of the OECD Commentary in Tax Treaty Interpretation*, 23 AUSTRALIAN TAX FORUM 95 (2008).

<sup>81</sup> BEPS Action 6: Paragraph 63 (“In order to be granted benefits under paragraph 5, the person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that there were clear non-tax business reasons unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance and that any reasons related to the obtaining of treaty

BEPS Action 6 represents a further step by the international community toward a more substantive method of tax treaty interpretation. Such method may operate as a *de facto* standard of professional ethics in treaty-based aggressive tax planning.

#### IV. Conclusion.

Legal advice rendered in furtherance of Double Non-Taxation raises professional ethics considerations, particularly for the U.S. tax lawyer. In general, Double Non-Taxation typically represents a form of indeterminacy planning where the tax lawyer may seek to capitalize on an undefined aspect of existing tax law. A specific example of a field of tax law where Double Non-Taxation often arises is tax treaty interpretation. Tax treaty interpretation is an art not a science.<sup>82</sup> Results of treaty interpretation are often indeterminate and variable depending, in significant part, on the method of legal interpretation applied by the interpreter. Since most tax treaty planning is not tested in the court system, the “interpreter” typically refers to the tax planner, who is often a tax lawyer.

In the context of tax treaties, the term “Double Non-Taxation” generally refers to double exemption by both the state of source and residence as nations party to the bilateral treaty. Since U.S. treaties rely generally on the credit method to avoid double taxation rather than the exemption method, Double Non-Taxation is not typically allowable as a matter of U.S. tax treaty interpretation. Other aspects of U.S. treaty interpretation with substantive aspects that may prevent the Double Non-Taxation outcome include the “subject to tax” clauses and the prohibition on artificial arrangements to obtain the benefit of a third-nation favorable treaty network with hybrid entities.<sup>83</sup> All of this represents a *substantive method* of legal interpretation including an evolving “single tax” principle as an international norm in treaty interpretation. Professional ethics for the U.S. tax lawyer means, in part, the following of international norms including the methodology of treaty interpretation. Partly as a result of ongoing OECD initiatives, tax treaty interpretation may presently, or in the near-future, require a substantive analysis of both U.S. *and* foreign tax treaties. Such substantive interpretational requirements may limit the ability of tax professionals to ethically plan toward artificial structures premised on formalized methods of treaty interpretation all leading to what Vogel/Rust optimistically referred to as “non-logical results”.<sup>84</sup>

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benefits were clearly secondary to those unrelated reasons and for the conduct of its operations in the other Contracting State.”).

<sup>82</sup> Linderfalk *supra* note 28.

<sup>83</sup> See Internal Revenue Code § 894(c).

<sup>84</sup> Vogel/Rust at 39.

